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OECD Economic Surveys: United Kingdom

Chapter 1

Making the most of globalisation

The United Kingdom's good macroeconomic performance over the past decade has been underpinned by a willingness to embrace the opportunities offered by globalisation, together with regulatory policies that promote efficiency and economic resilience. As a result, productivity growth has remained strong, while the workforce has been boosted by immigration in recent years. Nevertheless, the productivity gap with the United States remains large, and a number of reforms should be pursued in order to further improve growth performance. There is also a need to further reduce the government deficit. This will require much slower growth in government spending and more effort devoted to ensuring that publicly-funded services provide good value for money. In recognition of the need to support those who are least able to benefit from globalisation, policy has focused on supporting the poorest members of the population, with a continued emphasis on encouraging participation in work. Nevertheless, employment rates among the least skilled remain too low. A key challenge is to raise education performance without significant further increases in expenditure, while a related key challenge is to ensure strong incentives for the least skilled to participate in the labour market and to progress in work. Finally, it remains important to ensure that the tax structure preserves the United Kingdom's position as an attractive business location.

The UK's open and flexible approach to economic policy is reflected in support for free trade, openness to foreign direct investment (FDI), a willingness to open its labour markets to citizens from new EU countries that joined in May 2004,[1] and the adoption of regulatory policies that promote efficiency and economic resilience.

Macroeconomic performance has also been strong. The level of GDP per capita now ranks third in the G7 (after the United States and Canada) compared with bottom of this group 10 years earlier. The United Kingdom has pulled ahead of the euro area, particularly since 2000.[2] This strong performance is not only due to the willingness to embrace the opportunities offered by globalisation, but also to a period of strong trading partner growth, as well as strong institutional arrangements for setting monetary and fiscal policy. Nevertheless, while some progress was made in closing the gap in living standards with the United States and Canada in the first half of the 1990s, more recently the gap has remained unchanged. This suggests that there are areas where the economy could be doing better. Some of the key reform priorities – as highlighted in *Going for Growth* (OECD, 2007a) – include: improving transport infrastructure; raising the education achievement of young people; improving the work incentives for lone parents and second income earners; ensuring that publicly-funded services provide good value for money; and getting more disability-related benefit recipients back into work. The government has addressed many of these concerns – in part by raising government outlays. But despite improvement in some areas, the overall extent to which additional spending is paying off is not yet clear, and the fiscal deficit remains relatively large. The unemployment rate also crept up after 2004, particularly among young unskilled school-leavers, before stabilising at around 5.5%.

This *Survey* addresses these issues through the lens of the benefits and challenges posed by the forces of globalisation. To set the scene, the chapter begins with a brief review of recent macroeconomic performance and prospects. This provides the context for highlighting the key channels through which globalisation has benefited the economy, together with the ongoing challenges of: raising productivity growth; up-skilling the population; providing good incentives to participate in the labour market and progress in work; and ensuring that the tax structure preserves the United Kingdom's position as an attractive business location. Broadly speaking, these challenges are similar to those identified by the government in its own review of globalisation issues.[3]

Recent macroeconomic performance and outlook

Stable and healthy GDP growth continues but the outlook is now more uncertain

Output grew by 2¾ per cent in 2006, close to its trend rate, continuing the healthy record of economic stability established since the mid-1990s. There has been some rebalancing of growth away from consumer spending (consistent with subdued real income growth) and toward investment. Business investment in particular has picked up, while residential construction recorded a smaller recovery following some resurgence in housing market activity in 2005 and 2006. Estimates of the output gap have remained close to zero for some time (Figure 1.1). Job creation has also been significant, although a surge in

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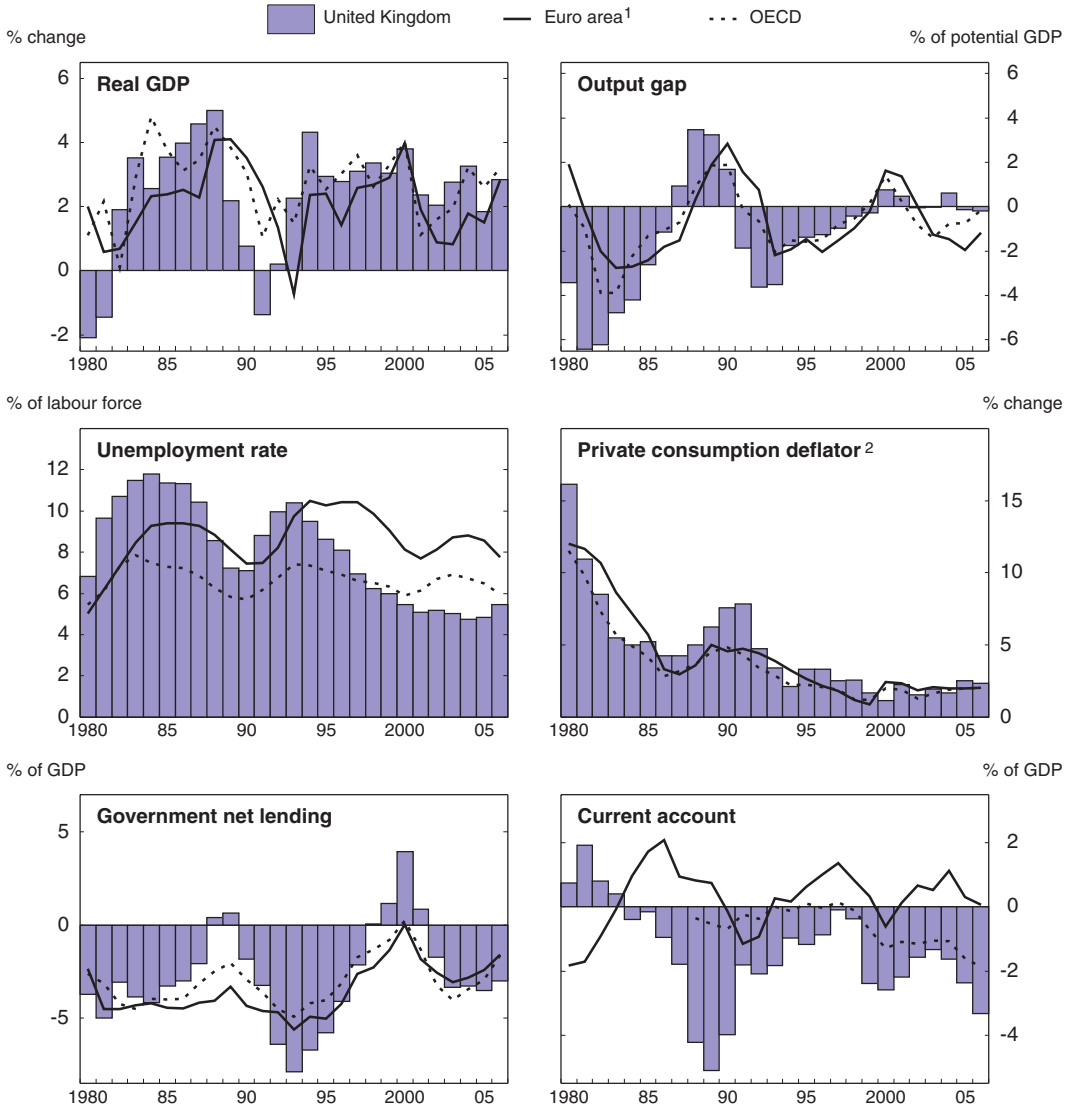
Figure 1.1. **Key indicators in long-term and international perspective**



1. Break in series in 1991: western Germany up to then, total Germany thereafter.
2. OECD excludes high inflation countries.

Source: OECD (2007), *OECD Economic Outlook: Statistics and Projections*, No. 81 – online database.

StatLink http://dx.doi.org/10.1787/115588376187

labour force participation has pushed up unemployment. Labour force growth was in part boosted by older workers delaying their retirement and considerable inward migration from the new EU member countries. Thus, although the unemployment rate had fallen to 4¾ per cent in 2004, it rose again to 5½ per cent by mid-2006 and has been broadly stable since.

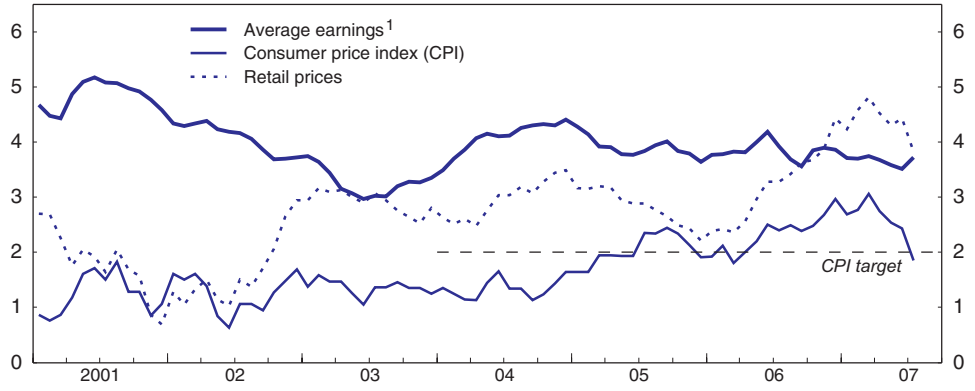
Prior to the recent financial market turmoil the OECD projected GDP growth to continue at a pace of around 2½ to 2¾ per cent per annum and inflation close to the 2% target. However, the outlook for both growth and inflation has now become more uncertain and there is a risk that growth will be weaker going forward, which could imply a need for interest rate reductions. A slowing in growth, together with reduced profitability in the City, could also reduce tax revenues and imply a rise in the budget deficit, which is still high by international comparison.

After a long period of low inflation, consumer price inflation picked up from under the 2% target in 2004 to peak at 3.1% in March 2007, before falling back to 1.9% in July. It is a testament to sound monetary management, as well as to the stability of economic conditions, that it took ten years after the Bank was given operational independence from the government before inflation moved more than 1 percentage point away from the inflation target. This outcome triggered the need for an open letter from the Governor of the Bank of England to the Chancellor setting out the reasons why inflation moved away from the 2% target and the policy action that the Monetary Policy Committee took to deal with it (King, 2007). Part of the explanation lies with the fact that the recent period has been characterised by unusually large fluctuations in energy prices; for example, a lack of non-discriminatory access to continental pipelines and gas storage together with insufficient import capacity during 2005 and early 2006 caused the wholesale price in the United Kingdom to rise by significantly more than in continental Europe. More recently, access to new gas pipelines and storage facilities are expected to facilitate the easing in prices throughout the remainder of this year and 2008.

In response to inflationary pressures, the Bank of England raised interest rates five times between mid-2006 and July 2007, bringing the policy rate to 5.75%. The higher interest rates, together with the recent financial market volatility, are expected to have a moderating impact on consumer spending and slow the pace of house price inflation.[4] To date, the growth in average earnings (excluding bonus payments) has been remarkably stable (Figure 1.2). Faced with an inflation spike driven by a supply shock, this is just what one would hope would happen – minimising the chance of the higher inflation rate becoming entrenched in higher inflation expectations. The government has played an important role by keeping the public sector wage settlements at an average of 1.9% for 2007/08 – the lowest in a decade.

Figure 1.2. **Wage inflation more stable than CPI inflation**

Year-on-year percentage change



1. Private sector excluding bonus payments; three month average.

Source: National Statistics website, *www.statistics.gov.uk*.

StatLink http://dx.doi.org/10.1787/115600578101

Inflation measures are not ideal

Although inflation risks have now receded, it remains of some concern that wage bargainers have typically used the retail price index (RPI) (which peaked at 4.8% in March 2007) as their measure of rises in the cost of living, rather than CPI inflation (which

peaked at 3.1%). Approximately 0.5 percentage point of the difference is due to the use of a different index formula in the RPI. Much of the rest reflects a significant increase in housing costs, which in the RPI typically overstates inflation in the true user cost of housing. It would be better to develop an alternative CPI inflation index that includes a comprehensive measure of housing costs, and encourage this to be used as a benchmark for wage negotiations. This would have the advantage of including an expenditure item that is important for most households. Such an index would also make international comparisons of inflation rates more meaningful (see Box 1.1).

Box 1.1. **The case for a new inflation index**

In December 2003 the Consumer Price Index (CPI)[1] replaced the Retail Price Index excluding mortgage interest payments (RPIX) as the basis for the inflation target that the Bank of England's Monetary Policy Committee is required to achieve. Since CPI inflation is typically lower than RPIX inflation,[2] the inflation target was lowered from 2.5% to 2.0% at that time.

Since then, RPIX inflation has taken on a lower profile, but RPI (all items) inflation has continued to play a very important role because it is historically the typical benchmark inflation index for the purposes of wage negotiations and also because the RPI and its derivatives are used to up-rate pensions, benefits and index-linked gilts. The RPI also has the advantage of the familiarity and credibility bestowed by the longer history of the RPI (whereas the RPI has been around since 1947, the CPI was only introduced in 1997).

Unfortunately, however, the importance of the RPI in the wage negotiation process could serve to unduly push up wage inflation, requiring a tighter monetary stance. This is due to two reasons. First, the RPI (unlike the CPI in the United Kingdom or elsewhere) uses the average of relatives (AR) arithmetic mean formula for the aggregation of individual item indexes. Relative to other formulae, this formula increases inflation rates by around 0.5 percentage point (largely because it does not capture the impact of consumers switching to cheaper brands or varieties of products when relative prices change). In contrast, the UK CPI uses the geometric mean (GM) formula which assumes complete substitution. Other countries' CPIs are also calculated using the GM formula, or alternatively using the ratio of averages (RA) formula which also produces results that are comparable with GM.[3] However, if the RPI index were to be re-calculated using a GM formula, this might require redemption of existing (RPI) index-linked gilts.[4]

Second, since 1995 the RPI has included a housing depreciation element, which is based on lagged house prices. However, because house price inflation reflects rises in the price of land, and since land does not depreciate, the price of housing typically overstates housing depreciation costs (Nickell, 2006). The user cost of owner-occupied housing would be better proxied by market rents (*e.g.* as in the US and Japanese CPIs) or measured directly as the user cost associated with owners' housing capital valued at market prices (as in the US Personal Consumption Deflator).[5]

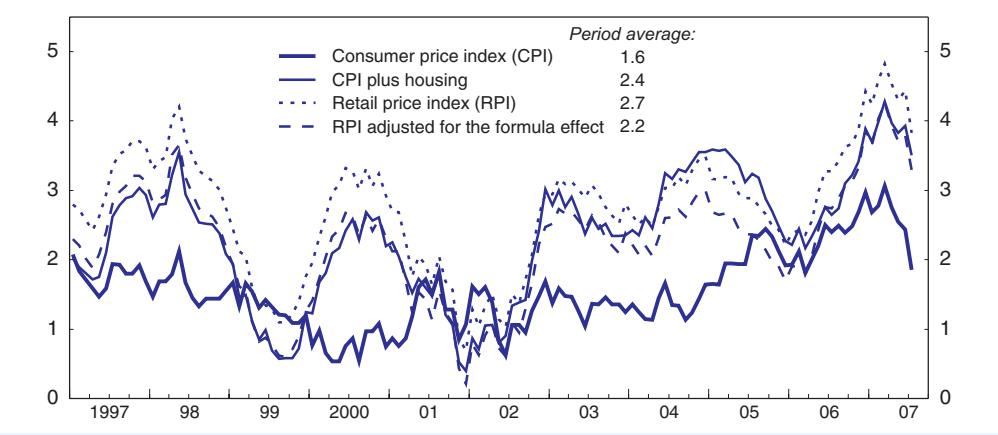
While the RPI suffers from these two disadvantages, the CPI is not an ideal choice as a reference index for wage negotiations either. This is because the CPI does not include the most important components of owner-occupied housing costs, which constitute an important expenditure item for most wage and salary earners. In recognition of this omission, the Office for National Statistics (ONS) is participating in a Eurostat task force assessing the possibility of including in the harmonised consumer price index (HICP) an index of owner-occupied housing costs. Although Eurostat identified this issue as a priority in 1997, final results of the pilots are not expected before the end of 2009.

Box 1.1. **The case for a new inflation index** *(cont.)*

What might an alternative inflation index look like? Figure 1.3 shows two indicative alternatives: RPI inflation adjusted for the formula bias; and CPI inflation plus the housing component of the RPI. Both of these alternative inflation rates average somewhere in between the CPI and RPI inflation rates, and normally tend to move quite closely together, with the exception of the 2004-05 period when other coverage differences between the two indexes served to push up the inflation rate of the CPI relative to the RPI.[6]

Figure 1.3. **Alternative measures of inflation**

Per cent



Source: National Statistics website, *www.statistics.gov.uk* and OECD calculations.

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Since such an alternative measure of inflation would be preferable to the RPI as an inflation benchmark for wage negotiations, the government should support the development of the CPI to include housing, either using the index development that the ONS has been undertaking, or by pushing for faster incorporation by Eurostat of housing costs into the HICP. A new index would also significantly assist international comparisons of inflation. At present, the CPI is comparable with HICP inflation rates for other EU countries. For non-EU countries, however, neither the RPI nor the CPI is comparable since the RPI suffers from the AR formula bias and the CPI excludes a measure of owner occupied housing cost, whereas all non-EU OECD countries' CPIs include such a component.[7]

1. The inflation index published as the CPI in the United Kingdom is the same as the Eurostat measure of the Harmonised Index of Consumer Prices (HICP).
2. Since January 1997, CPI inflation has averaged 0.7 percentage points lower than RPIX inflation.
3. See ONS (2007) for further discussion.
4. The prospectus for index-linked gilts states that if any change should be made to the coverage of the basic calculation of the (Retail Prices) Index which, in the opinion of the Bank of England, constitutes a fundamental change in the index which would be materially detrimental to the interests of stockholders, the Treasury is required to offer gilt holders the right to redeem their stock.
5. See Cournède (2005) for further discussion of alternative ways of measuring owner-occupied housing costs.
6. For example, the CPI includes items such as unit trust and stockbroker charges, overseas students' university fees and other accommodation costs in university halls of residence, which are excluded from the RPI.
7. For further details see Christensen *et al.* (2005).

Fiscal policy

The government's fiscal policy objectives are implemented through two fiscal rules, against which the performance of fiscal policy is judged. The *golden rule* states that over the economic cycle, the government will borrow only to invest and not to fund current spending. The *sustainable investment rule* states that public sector net debt as a proportion of GDP will be held at a stable and prudent level (currently defined as being less than 40% of GDP). The fiscal rules have been successful in a number of respects. For example, by separating current and capital spending, the fiscal rules have helped the government to tackle the UK's historical bias against capital spending. Compared with previous economic cycles, the introduction of fiscal rules and clear objectives for fiscal policy have also helped to put the public finances on a more sound and sustainable footing.

In Budget 2007 the Treasury estimated that the cycle that began in 1997 may have ended in early 2007, although this assessment is yet to be confirmed. Over this period it is likely that the golden rule was met, since it is estimated that the cumulative current budget balance over this period was around 0.1% of GDP.[5] The general government fiscal balance is estimated to have averaged –1.3% of GDP over the same period, with a large surplus early on and a large deficit later.

Relative to fiscal outcomes in the previous two decades, this is a positive outcome, and the golden rule deserves credit for helping to constrain fiscal discretion. Nevertheless, given that the golden rule is expected to be met by such a small margin, a binary "success" judgement seems inappropriate, just as a "failure" judgement would be inappropriate if the rule was to be missed by a similar margin. Experience with the golden rule over the past 10 years has highlighted two weaknesses. First, the credibility of the golden rule may have been undermined to some extent by revisions to the start and end dates of the economic cycle, since these revisions occurred at times when it appeared likely that the rule might not be met (see Chote *et al.* [2007] for a detailed discussion). This problem stems largely from the difficulties associated with estimating the output gap and dating the cycle; different techniques produce different results and all are subject to data revisions. It is particularly difficult to date the end of a cycle *ex ante*. Second, the "over the cycle" formulation of the rule means that the goal of permitting automatic stabilisers to operate fully may be compromised if pro-cyclical fiscal tightening is required towards the end of a cycle in order to meet the rule (as illustrated by Honjo [2007]). Related to this, the fact that the cycle may have recently ended with a current deficit means that a tighter fiscal policy will be required over the new cycle, as foreseen in Budget 2007 fiscal projections. An international comparison shows that the UK fiscal balance is in a relatively worse position than most of the other G7 countries; the most recent data shows smaller deficits in France, Germany and the United States, while Canada continues to run a fiscal surplus. However, UK net debt as a percentage of GDP is lower than in all the other G7 countries except Canada.

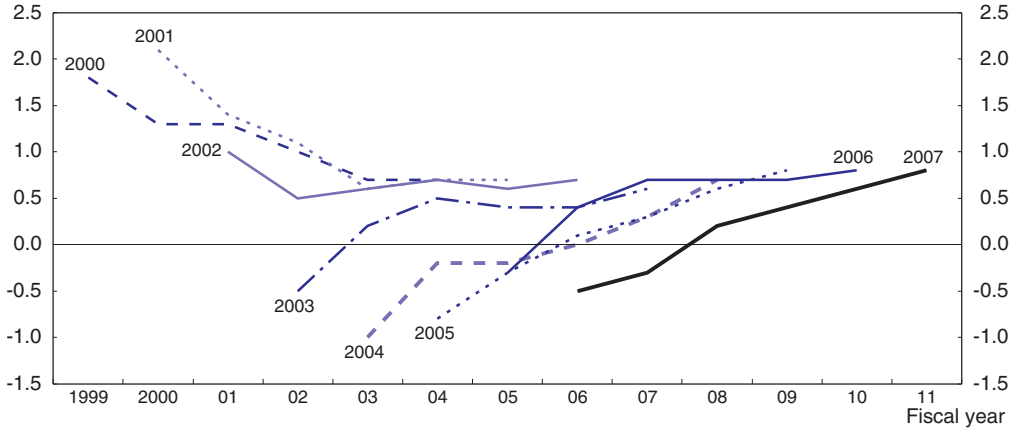
Scope for improving the golden rule

To address these concerns, a number of suggestions have been made. To address the credibility concern some economists have suggested that estimating the output gap and identifying the cycle could be contracted out to an independent body. Another possibility, that would address both the credibility and pro-cyclicality concerns, is to reduce the reliance of the rule on cycle dating and the output gap altogether. Such an approach is

supported by the fact that the amplitude of the economic cycle has become much smaller – at least partly thanks to a reduction in policy-induced shocks – and a clearly defined economic cycle is now harder to identify (as illustrated by the output gap panel in Figure 1.1). Instead of aiming to balance the current budget over a cycle, the Treasury could instead aim for a particular (positive) target level for the current budget balance over an appropriate time horizon. As pointed out by Chote *et al.* (2007), the history of current budget balance forecasts suggests that fiscal policy is already run as though it expects to deliver a current budget surplus of around 0.7% of GDP after five years (Figure 1.4). However, in the event that non-policy shocks are more pronounced in future economic cycles, it may not be optimal to attempt to target such surpluses within a five year horizon.

Figure 1.4. **Successive budget forecasts have had a similar end-point**

Cyclically-adjusted current budget surplus in per cent of GDP



Source: HM Treasury, Budget Reports.

StatLink http://dx.doi.org/10.1787/115607248748

A more forward-looking fiscal rule would have several advantages. First, it would not be necessary to cyclically adjust the current budget balance since it could be assumed that any output gap would have closed within a five year period. Second, there would be no need to date the cycle. Third, it would permit the automatic stabilisers to operate fully. Fourth, it would redirect attention from the binary judgement of whether or not the golden rule has been met, to the broader picture of fiscal policy. Finally, the desire for fiscal policy credibility, in the absence of a binary "success" judgement, might encourage the Treasury to improve fiscal transparency and more explicitly quantify the uncertainties inherent in their fiscal projections. The Treasury Select Committee's report on the 2007 Budget (House of Commons, 2007a) also recommended that the government review the golden rule with a view to making it more forward-looking and less dependent on the dating of the economic cycle.

Since such an approach would be forward-looking, the Treasury would not be required to make up for past slippage (in the event of larger than expected deficits over the past few years) or be permitted additional fiscal loosening (in the event of unexpectedly good fiscal outturns). It is this forward-looking feature of the rule that would ensure that the automatic stabilisers could work, even towards the end of a cycle. Nevertheless, accountability for past policy and forecasting errors would take on greater importance. In particular, unbiased revenue projections would become more important under a forward-looking rule, suggesting a potentially greater role for auditing of the Treasury's

assumptions. While the National Audit Office (NAO) is auditing some specific assumptions, a requirement for broader NAO audit of key fiscal assumptions would significantly enhance fiscal accountability.

What target level might be set for the current balance five years ahead? Although the golden rule targets *balance* in the current budget over the course of the cycle, in practice this goal is interpreted as requiring a balance or surplus. It would also make sense for a rolling forward-looking target to be positive, for three reasons: first, the Treasury's forecasts for the public finances have generally been over-optimistic since 2001, suggesting a need for some buffer if persistent deficits are to be avoided; second, even if Treasury forecasts switch to being consistently pessimistic (and there is evidence that forecast errors tend to be serially correlated) there is a case to be made for targeting a small surplus (say ¾ per cent of GDP) in order to make some compensation for the government's growing off-balance sheet liabilities (see following discussion); third, a positive target would be required to avoid the forward-looking rule imposing a looser constraint on debt than does the golden rule (Honjo, 2007).[6]

Complementing the sustainable investment rule with other liability measures

While the golden rule explicitly permits the government to borrow to pay for capital investment, it only requires that the current budget is in surplus or balance over the cycle, and so doesn't by itself explicitly address the perceived need to go further in preparing the public finances for the long-term challenges due to the ageing of the population. To address these concerns, the sustainable investment rule puts a limit on the extent of borrowing by requiring that the public sector's net debt remains at a "stable and prudent" level. Over the economic cycle that began in 1997 this was defined as a level of less than 40% of GDP. Over the past decade, net public debt was first reduced from 44% of GDP in 1997 to around 30% in early 2002 before it began to gradually trend up again, reaching 37% in April 2007. Looking ahead, net public debt is expected to rise slightly further in the near future. Sustainable debt calculations suggest that, under plausible assumptions, the government could sustain public sector net investment of around 2% of GDP a year without breaching the net public debt ceiling.[7]

An overall assessment of fiscal sustainability should, however, also consider the government's off-balance-sheet liabilities and long-term spending and revenue trends. Table 1.1, based on Chote *et al.* (2007), compares the size of public sector net debt (around 37% of GDP) with official estimates of three other public sector liabilities: *i)* public sector pension liabilities; *ii)* the future flow of payments to private finance initiative (PFI) providers under contracts already signed; and *iii)* Network Rail obligations. Official

Table 1.1. **Estimated value of various future public sector obligations**

	Date	Billion £	% of GDP
Public sector net debt	April 2007	498	37
Public sector pension liabilities (estimate)	March 2005	530	≈ 42
Future PFI liabilities, signed deals (estimate)	December 2006	100	≈ 8
National rail debt	September 2006	18	≈ 1
Total		**≈ 1 100**	**≈ 87**

Source: Public sector net debt from HM Treasury; public sector pension liabilities from the Government Actuary's Department, available at: *www.gad.gov.uk/Pensions/docs/2006_Public_Sector_Pension_Cashflow_projections_methodology.pdf*; future PFI (private finance initiative) payments from Table B24 of HM Treasury (2006), *Pre-Budget Report*; Network Rail debt from Table 9, of Network Rail Ltd, *Interim Financial Statements, six months ended 30 September 2006*.

estimates of these other liabilities are not as up-to-date as those for public sector net debt. A full actuarial valuation of public sector pension liabilities, for example, is normally undertaken only once every four years. However, the government publishes annually the Long-Term Public Finance Report, which provides a comprehensive assessment of long-term fiscal sustainability and which has discussed the different types of liabilities that exist. Since 2004 the Long-Term Public Finance Report has also shown public service pension projections – produced by the Government Actuary's Department – explicitly.

Table 1.1 shows that unfunded public sector pension liabilities are larger than total net public sector debt. Not only that, but the £530 billion estimate is expected to be revised up.[8] The government should also take other actions to reduce the size of these liabilities. For example, further changes could be made to public sector pension schemes to reduce the size of liabilities. In 2005 the government renegotiated a policy to raise the normal public sector pension age from 60 to 65 for existing workers from 2013 in return for a commitment from unions that they would agree to negotiate other reforms to the pension schemes that would recover equivalent costs to those lost by retaining the existing pension age of 60 for existing workers (*e.g.* by reducing pension generosity and/or by raising employee contributions). Since scheme-specific negotiations are still ongoing, the final savings figure is not yet known. Meanwhile, recent reforms to the basic State Pension include some further increases in the private sector retirement age and should improve private saving incentives (Box 1.2).

Box 1.2. **Recent changes to the State Pension System**

In addition to addressing poverty concerns, one of the key policy goals of reforming the state pension system was to improve incentives for voluntary savings, particularly among low and middle-income earners – by improving coverage, reducing the extent of means-testing, particularly its expected growth in the future, and by simplifying the rules. These challenges were discussed in more detail in the last *Economic Survey* (OECD, 2005a).

The 2007 Pensions Act is expected to address these concerns through a number of channels:

- From 2010 the basic State Pension will become more widely available (by increasing the contributory credits available for caring responsibilities and by lowering the minimum number of contribution years to 30).
- From 2012 (subject to affordability) the basic State Pension will be up-rated on the basis of increases in average earnings instead of prices. As well as making the basic State Pension more generous, this should significantly reduce the number of people who would qualify for means-testing in future.

A second Pensions Bill later this year will introduce private pension reforms from 2012:

- Automatic enrolment, mandatory 3% employer contributions, and a new low cost scheme of personal accounts should encourage higher take up of private pensions and ensure that earners (particularly low-to-middle-income earners) have access to a simple, low cost pension scheme in which to save.

With respect to the fiscal implications, higher take up of private pensions, including in personal accounts, will increase the cost to the government of pension-scheme-related tax relief. In the longer term there will be some offsetting cost savings as the retirement age for women increases from 60 to 65 between 2010 and 2020, before increasing gradually for both men and women after that in line with increases in life expectancy, reaching 68 by 2046. Nevertheless, there remains scope to further simplify the state pension system and to consider ways to further enhance savings incentives for low to middle-income earners.

The other two public sector obligations are smaller, although future PFI liabilities are significant. PFI initiatives are often a cost-effective way of financing public investment. However, compared with conventionally-financed investment projects, PFIs typically add less to public sector net debt (because they do not capture future government liabilities in terms of the commitments to pay private firms a rental price for the use of capital assets). Thus, as long as public finance assessments focus predominantly on net public debt statistics, fiscal transparency is reduced, and the government may have an incentive to finance more projects *via* PFI or public-private partnerships in order to keep a lid on the monitored statistic (net public sector debt). To prevent this, the government should set a ceiling on a broader measure of public sector liabilities. In addition, the 40% ceiling for public sector net debt should be confirmed for the new economic cycle. Box 1.3 summarises the proposed improvements to the fiscal rules.

Box 1.3. **Improving the fiscal rules**

Both the golden rule and the sustainable investment rule have played an important role in anchoring expectations and improving the transparency of fiscal policy. However, the rules have some important limitations. This box summarises the proposed improvements.

Reduce the reliance of the golden rule on cycle dating and output gap estimates

- Reformulate the golden rule to make it less dependent on cycle dating, for example by targeting a positive level for the current budget balance over an appropriate time horizon (*e.g.* five years). This should be accompanied by a requirement for a broader NAO audit of key fiscal assumptions.
- Introduce mechanisms that put a tighter constraint on overall spending by preventing the spending of cyclical revenue windfalls.

Take greater account of off balance sheet liabilities

- Publish estimates of other public sector liabilities on a regular basis alongside those of public sector net debt.
- Confirm the 40% ceiling for public sector net debt and set a ceiling for a broader measure of public sector liabilities.

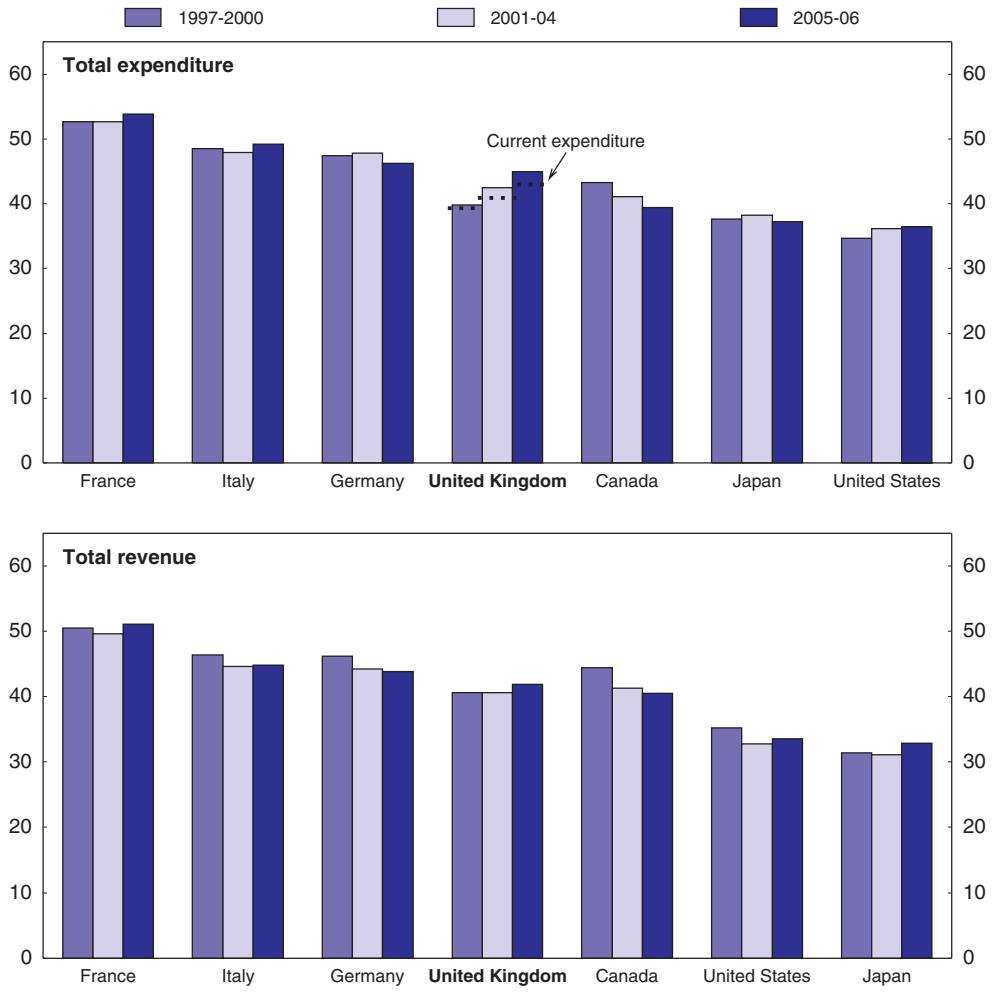
The 2007 Spending Review will be challenging

In many other OECD countries, expenditure rules are becoming a popular way of ensuring fiscal discipline (Guichard *et al.*, 2007). Expenditure rules have two main merits: they force governments to prioritise spending within a fixed overall envelope; and they avoid the risk inherent in fiscal or current balance targets of running pro-cyclical fiscal policy in good times, forcing counter-cyclicality when the economy turns down.[9] By contrast, the UK's *Spending Review* framework provides a relatively comprehensive means for controlling government spending at the departmental level on the basis of fixed, three-year Departmental Expenditure Limits (DEL) for each government department which account for 60% of public expenditure. However, it does permit the expenditure limits to be revised upward to reflect both discretionary policy decisions (such as education initiatives announced in the last Pre-Budget Report) and non-discretionary items (such as the cost of military operations in Iraq and Afghanistan) where this is consistent with meeting the fiscal rules (for example, if government revenues are stronger than expected or if the limits

of the rule are not yet binding). Actual real spending has indeed exceeded that planned in all Spending Reviews since 1998 and in some cases substantially so (IFS, 2007). This reflects, in large part, the government's preference for higher government spending to the extent permitted within the broader framework of fiscal sustainability as implemented through the fiscal rules. As a share of GDP, total government spending has crept up and is now approaching that of Germany. Government spending as a percentage of GDP has already overtaken that of Canada in the last 10 years, and if it overtakes that of Germany this year, the United Kingdom will move into the 3rd highest spending position in the G7 (Figure 1.5, upper panel).[10]

Figure 1.5. **Government expenditure and revenue**

Per cent of GDP



Source: OECD (2007), *OECD Economic Outlook: Statistics and Projections*, No. 81 – online database.

StatLink http://dx.doi.org/10.1787/115610211167

After its peak in 2000, general government net lending as a per cent of GDP deteriorated significantly, before gradually beginning to improve again more recently (see Figure 1.1). The larger than expected deficits over the 2001-04 period were due to a combination of falling public sector current receipts as a percentage of GDP together with

a deliberate government decision to significantly raise current expenditures as a percentage of GDP over this same time period. More recently, current receipts have recovered to previous levels and the deficits can be attributed largely to higher rates of expenditure. As a result, the next economic cycle – if it begins this year – will start with a current budget deficit, suggesting that higher revenues or lower spending will be required to meet the golden rule over the next cycle. Raising the tax burden further is not an attractive option. Many economists (*e.g.* Botman and Honjo, 2006) argue that it would be better to reduce transfers or spending than to raise taxes, due to the adverse effects of higher taxes on labour supply and capital accumulation – and this *Survey* argues that human capital is an increasingly important component of capital accumulation. While the government has announced that it will not raise VAT and income taxes, it projects that the tax/GDP ratio will rise by 0.8% of GDP between 2006/07 and 2008/09. Much of this increase is due to fiscal drag,[11] which should be seen as an explicit policy choice for raising additional revenues. Indeed, Figure 1.5 (bottom panel) shows that the tax burden has crept up over the last 10 years, compared with small decreases in four of the other G7 countries. The fiscal framework should also be transparent about fiscal drag, either through indexing tax brackets to wage growth or through efficiency enhancing tax reform. Chapter 5 discusses the possible impacts of globalisation on the tax structure.

The government agrees that slower spending growth is required and the 2007 Budget projects that total public spending will grow by around half a percentage point more slowly than GDP in each of the three years from 2008/09 to 2010/11 (after having expanded by around 0.9% faster than GDP on average between 2000/01 and 2005/06). Public spending as a percentage of GDP is now projected to fall by about 0.6 percentage points over the next three-year period. This tight overall envelope sets the scene for a tough Comprehensive Spending Review, with the allocation of this envelope between departments and priorities due to be announced in October 2007. Roughly 30% of the Departmental Expenditure Limits (DEL) had already been announced by Budget 2007, including those for education and science, which will see their expenditure growing in line with GDP. More challenging allocations – involving expenditure settlements of spending declines or no real growth – have been announced for some other ministries, although these cover only around 10% of total DEL. The National Health Service (NHS), which has seen the largest spending increases over the past decade, is likely to see expenditure rising further as a percentage of GDP. Although some hospital trusts are continuing to run deficits, the overall position of the health system's finances improved over 2006/07. Nevertheless, further efficiency gains will be required if the NHS is to achieve its key targets without a return to the large deficits of 2005/06. After strong growth in public sector earnings in previous years the government is so far succeeding in restraining average public sector salary increases in 2007. This is important in order both to limit government expenditure and to ensure that wage increases are consistent with the 2% inflation target. Overall, raising the efficiency of public sector spending remains a key challenge facing the government and more efforts need to be made to ensure that higher expenditure results in significantly higher standards of service delivery. Concerning education, Chapter 2 discusses the need to focus more on encouraging higher educational attainment, without significant further increases in expenditure, while Chapter 4 assesses spending on transport, another priority area.

Globalisation has contributed to strong productivity growth

While the UK's openness to the forces of globalisation is not new, the recent emergence of low-cost countries such as China has led to an intensification of both international trade and foreign direct investment (FDI), both of which have grown much faster than GDP (see OECD, 2007b for a discussion of globalisation trends).

Increasing trade in services has been another important feature of globalisation in recent years – underpinned by advances in communications technology. Yet overall it is still at relatively low levels; total trade in services accounted for only around one-third of that in goods in 2005 (Figure 1.6, upper panel). In terms of export market share, however, the UK economy is performing better in services (middle panel). In most components of services the United Kingdom runs a trade surplus, with the travel and transportation components being important exceptions (bottom panel). Overall, the surplus on trade in services (around 2½ per cent of GDP) plays an important role in mitigating the deficit on trade in goods (around 6% of GDP) although the current account deficit was still 3.6% of GDP in the first quarter of 2007.

For both goods and services the United Kingdom trades most with other OECD countries. Although the share of non-OECD countries in total world trade has risen from around one quarter at the start of the 1990s to around one-third, non-OECD countries accounted for only about 20% of total UK trade in 2004; the UK's largest single trading partner is the United States (approximately 10% of total goods trade and 20% of total services trade), although the euro area as a whole is much more important (50% of goods trade and 40% of services trade). The UK's exports to China are still very small (up from 0.5% of total exports in 1995 to 1.3% in 2005), but imports from China are becoming more important (up from 1% of total imports in 1995 to 3.7% in 2005).

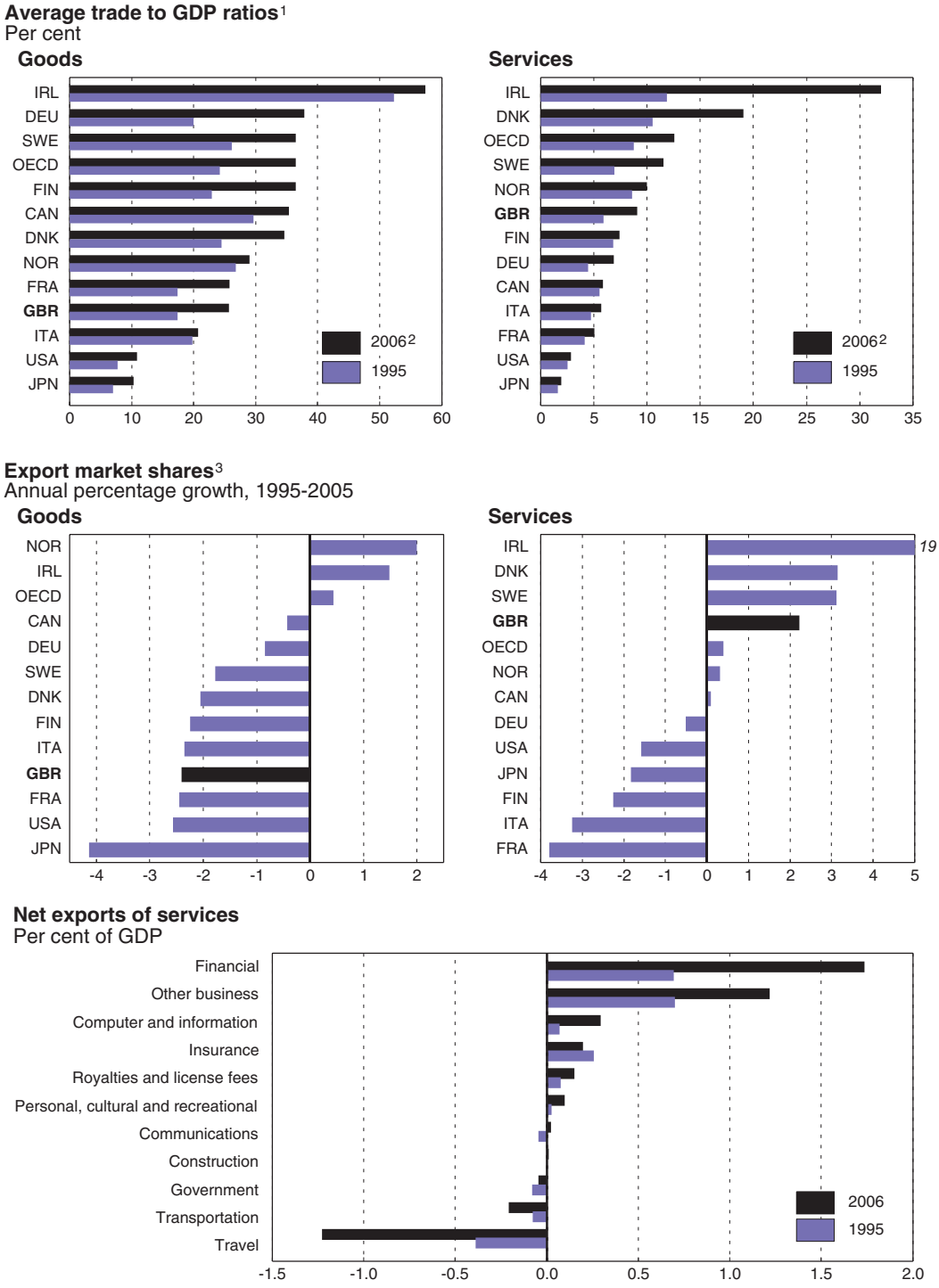
Compared with trade, financial transactions have been an even faster-growing segment of international transactions and FDI statistics reflect the increasing interdependence of the United Kingdom with other economies. In absolute terms the United States has traditionally been both the largest foreign investor and the largest recipient of FDI flows in the OECD. When measured as a share of GDP, however, the relative importance of the United Kingdom as a destination and source of FDI becomes more evident (Figure 1.7, upper panel). However, a large proportion of FDI has been driven by acquisitions and mergers, *i.e.* a change of ownership, rather than creation of new businesses or capacity enlargements of existing firms.[12]

Trends in the components of FDI flows are consistent with the increasing importance of the services sector. Between 1992 and 2003, the UK's inward and outward investment positions in services rose from around 40% of total FDI to around 60%. While the manufacturing share of total FDI dropped, both inward and outward manufacturing sector FDI still increased as a percentage of GDP (Figure 1.7, lower panel).

The forces of globalisation have shaped the economy

The UK philosophy of openness to international economic forces is reflected in a general absence of protection for failing industries. The manufacturing sector has shrunk as a proportion of economic output (to less than 15% of total gross value added), with resources shifting to areas of comparative advantage, such as business services. Indeed, the share of business services in total economy-wide value added increased from less than 1.5 times that of manufacturing in 1980 to more than 3.5 times by 2003 (Figure 1.8, upper panel). While most other G7 countries have also experienced declining value added shares

Figure 1.6. **Trade indicators**



1. Calculated as ([exports + imports]/2)/GDP*100. OECD is an unweighted average excluding Belgium.
2. 2004 for Mexico; 2005 for Canada, Ireland, Japan (estimated), United States and OECD.
3. In current prices. OECD is an unweighted average.

Source: OECD (2007), *National Accounts of OECD Countries* – online database, September; IMF (2007), *Balance of Payments Statistics* – CDROM, August; National Statistics website (2007), *Balance of Payments: Trade in Services*, June, *www.statistics.gov.uk*.

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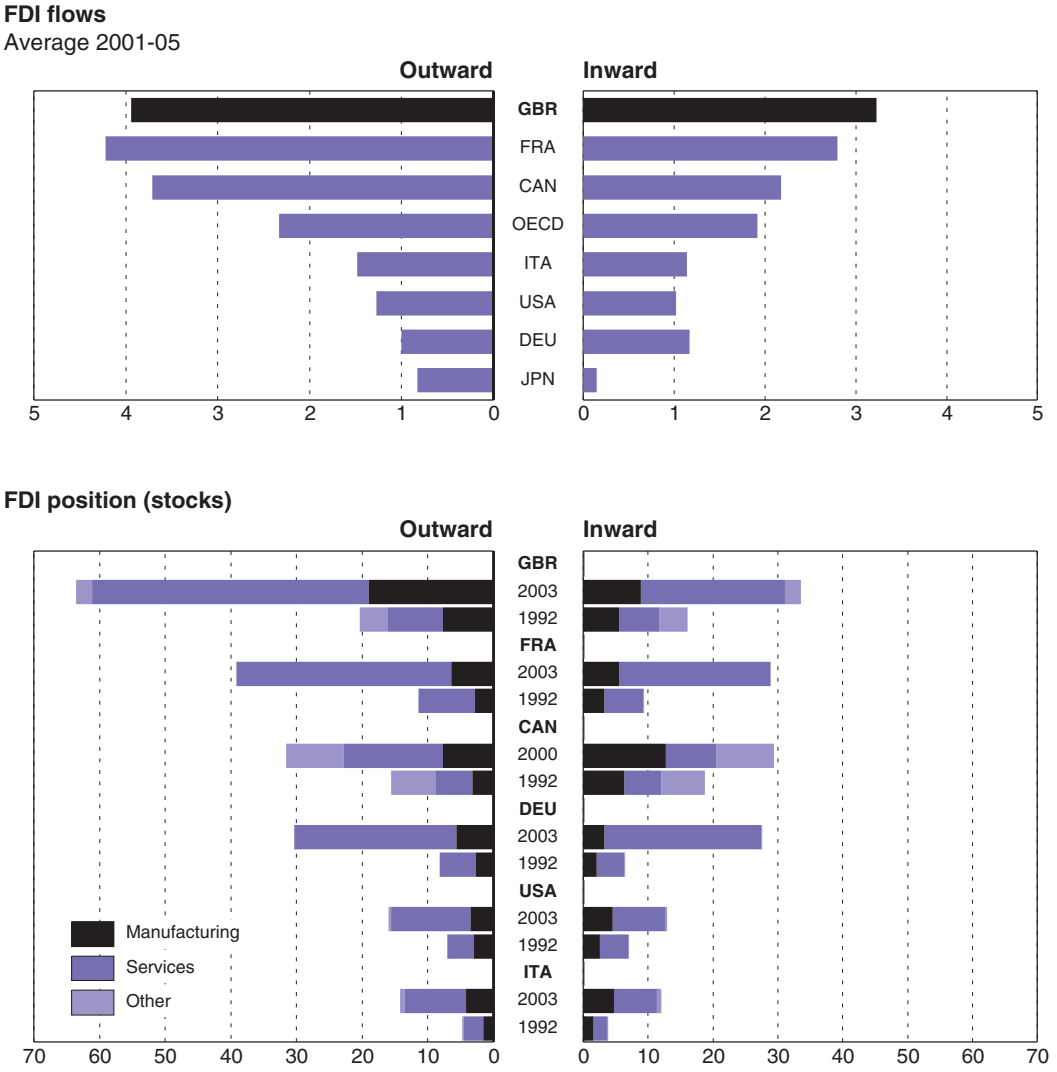
Figure 1.7. **Foreign direct investment in the G7 – flows and stocks**

Per cent of GDP



Source: OECD (2007), *International Direct Investment Statistics* and *National Accounts of OECD Countries* – online databases, January.

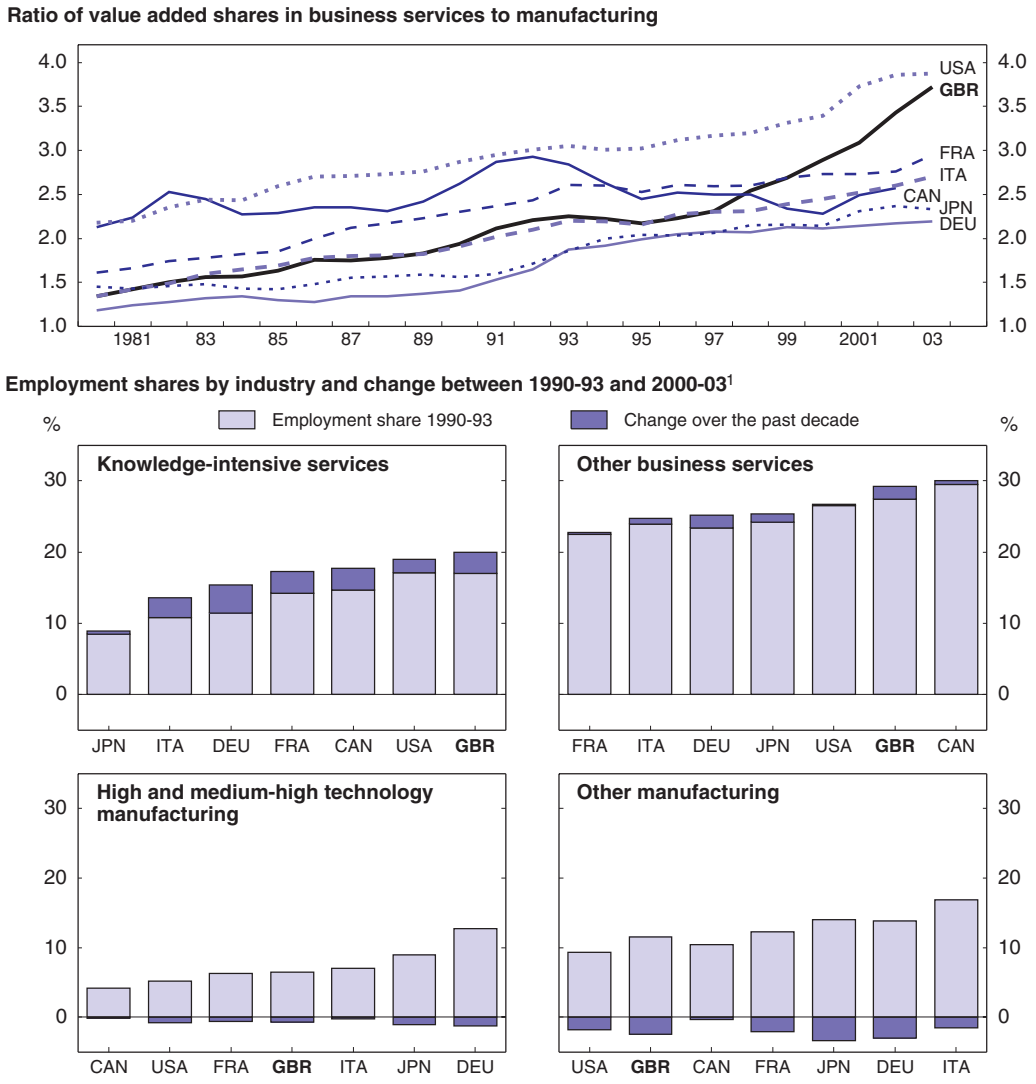
StatLink http://dx.doi.org/10.1787/115633335218

in manufacturing[13] and all have experienced rising value added shares in business services, these trends have been the most marked in the United Kingdom.

Similar trends can also be observed in employment. Figure 1.8 (lower panel) shows that by the early 1990s the United Kingdom already had one of the largest shares of employment in business services (relative to the other G7 economies) and one of the lowest in manufacturing. Even so, employment has continued to shift in this direction, particularly into knowledge-intensive services, where the United Kingdom now has the largest employment share among the G7, outstripping the United States.

Even though trade openness is facilitating the process of creative destruction in the United Kingdom, the results of a poll released at the end of 2006 (GMF, 2006) suggest that British workers are more likely to view free trade in a positive light than people in the other

Figure 1.8. **The resource shift from manufacturing to services can be seen in value added shares and in employment**



1. For Germany and France, data is up to 2002 only. For Japan the knowledge-intensive services definition excludes post and communications as data is not available since 1999. For the United Kingdom, high-technology manufacturing data is available up to 2002 only. For Italy service sector employment data begins in 1992.

Source: OECD (2006), *STAN Indicators database*, *www.oecd.org/sti/stan/indicators*.

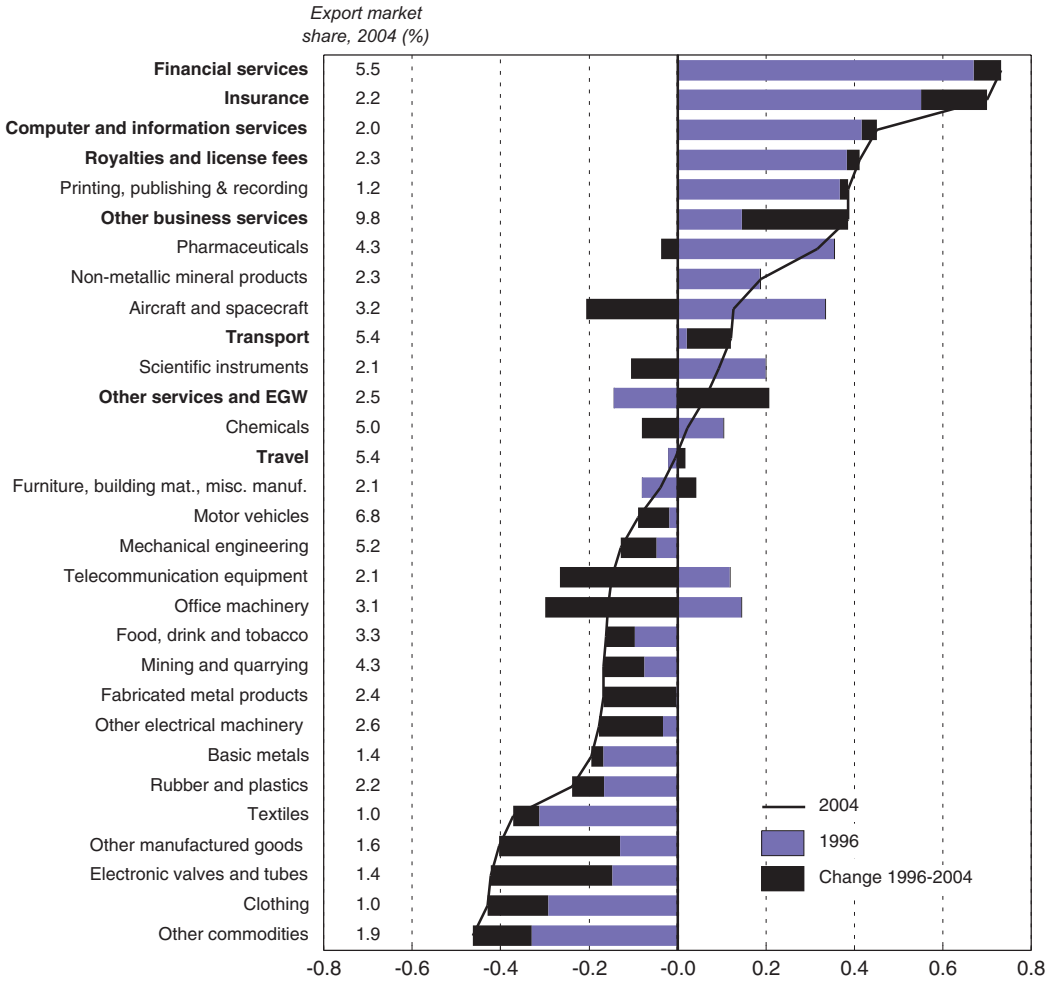
StatLink http://dx.doi.org/10.1787/115650647310

six countries polled (France, Germany, Italy, Poland, Slovak Republic and United States). Although half of all UK respondents thought that freer trade costs more jobs than it creates, this proportion was lower than in all the other countries except Poland. Perhaps more importantly, 77% of respondents in the United Kingdom thought that they benefited personally from free trade – more than in any other country polled. Relatively positive public opinion in the United Kingdom may reflect the government's more positive attitude to free trade (relative to that of the United States and most other European countries), together with the support of trade union and business leaders.

Finally, the resource shift from manufacturing into services is also evident in measures of export specialisation. Figure 1.9 uses the Revealed Symmetric Comparative

Figure 1.9. **Trade data also illustrate the UK's comparative advantage in services**

Degree of specialisation measured by the Revealed Symmetric Comparative Advantage (RSCA) index in selected sectors (service sectors shown in bold)[1]



1. RSCAs are shown for all commodities whose UK export share is more than 1%. Others are aggregated into three combined categories as follows: 1) Other services and EGW – construction; electricity, gas and water supply; government services; communications; personal, cultural and recreational services. 2) Other commodities – forestry; wood and products of wood and cork; mineral oil refining, coke and nuclear fuel; leather and footwear; agriculture; pulp, paper and paper products; fishing. 3) Other manufactured goods – building and repairing of ships and boats; radio and television receivers; railroad equipment and transport; insulated wire; other instruments (optical instruments and photographic equipment).

Source: OECD calculations based on the United Nations COMTRADE and UNCTAD databases.

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Advantage (RSCA) index to illustrate the UK's degree of specialisation in different export sectors.[14] This analysis shows that it is the service sectors in which the United Kingdom currently enjoys a higher than average export market share, and also that the UK's degree of specialisation in these sectors has increased over the past decade.

While the importance of manufacturing has been sliding relative to that of services, the United Kingdom still boasts a number of world class manufacturing firms. These firms tend to be in those sectors in which the United Kingdom continues to enjoy a higher than average export market share (see Figure 1.9): printing, publishing and recording; pharmaceuticals; non-metallic mineral products; aircraft and spacecraft; scientific

instruments; and chemicals. However, in most of these sectors the UK's degree of specialisation has been slipping over the past decade. Moreover, Figure 1.9 shows that in all other manufacturing sectors the United Kingdom now has a negative RSCA index (implying a lower than average export market share), and that the United Kingdom has been further reducing its specialisation in these sectors over the past decade.

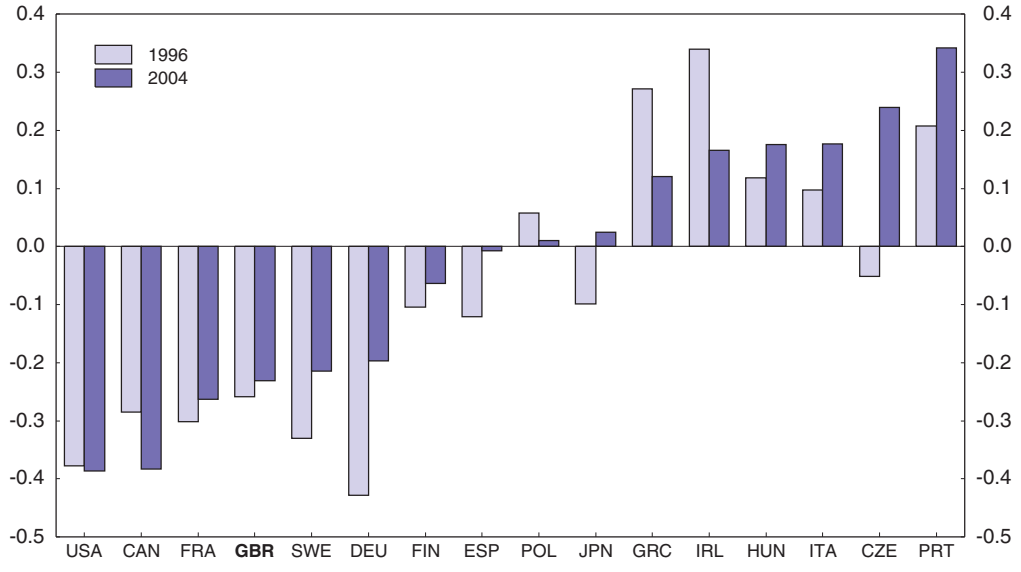
Service sectors are less exposed to competition from emerging markets

While these resource shifts are, in part, a *response* to the emergence of economies heavily endowed with unskilled labour, such as China, the UK's pattern of economic specialisation seems to have already been poised to benefit from such globalisation. If economic policy had protected low-skill-intensive industry in the late 1970s and 1980s, the more recent competition from emerging markets might well have proven fatal for these industries, prompting costly adjustments. Instead, by the mid-1990s the United Kingdom had already developed a specialisation in sectors (such as financial services) that are less exposed to competition from emerging low-wage economies such as China. The sectors in which the United Kingdom has specialised are also some of the fastest growing sectors.

Consistent with Coleman's (2006) model, the United Kingdom has thus been able to benefit from globalisation in the form of a rising terms of trade (discussed further below). Not surprisingly, the correlation between the United Kingdom's RSCA index in the different export sectors and that of the dynamic Asian economies is negative, implying that there is little head-to-head competition and globalisation is more an opportunity than a threat (Figure 1.10).

Figure 1.10. **RSCA correlations between selected OECD countries and the dynamic Asian economies**[1]

In 44 aggregated sectors



1. The correlation is a rank correlation between the Revealed Symmetric Comparative Advantage (RSCA) of each OECD country with those of the dynamic Asian economies (Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; Phillipines; Singapore and Thailand) plus China and India. These latter RSCAs are calculated using extra-regional trade data except for services where it is not available. In the case of missing data on services exports it was assumed that a country's exports grew at the same rate as world growth in that service.

Source: OECD calculations based on the United Nations COMTRADE and UNCTAD databases.

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However, during the last 10 years the UK's exposure to and degree of competition with the emerging markets seems to have increased slightly. On the one hand this may suggest diminishing complementarities in export patterns with the emerging markets and increasing competition. On the other hand it could be interpreted as indicating the development of intra-industry trade. In contrast to the United Kingdom, some southern (Italy, Portugal) and eastern European countries already have significant positive correlations between their sectoral specialisation and that of the dynamic Asian economies. The high correlation for Ireland is harder to interpret, given its sensitivity to aggregation effects.[15]

Globalisation has helped to keep productivity growth strong

Although UK productivity growth has lagged that of the United States in recent years (see Chapter 4 for further discussion) there is a growing body of evidence indicating that the impact of globalisation has been positive. In other words, it is likely that productivity growth would have been slower – perhaps more in line with that of the United Kingdom's large European neighbours – in the absence of policies that promote openness and attract foreign investment.

There are at least three channels through which globalisation can spur productivity, and some of these have already been operating for some time. First, openness to trade promotes competition and encourages the weakest firms to exit the market. Second, openness to FDI and the presence of foreign multinational enterprises can facilitate technological transfers and spill-overs of best practice to domestic firms. Third, and more recent, advances in information and communication technologies have eroded the boundaries between tradable and non-tradable goods and reduced the need for different stages of production to take place near each other. This has led to the geographical fragmentation of value-added chains, permitting firms to cut costs in low value-added areas through offshoring and redirecting resources to what they do best (see Baldwin [2006] for an overview). Outsourcing or offshoring[16] of key business inputs (such as the provision of information and communication technology [ICT] services) has become common, and this may also facilitate the diffusion of productivity enhancing technologies.

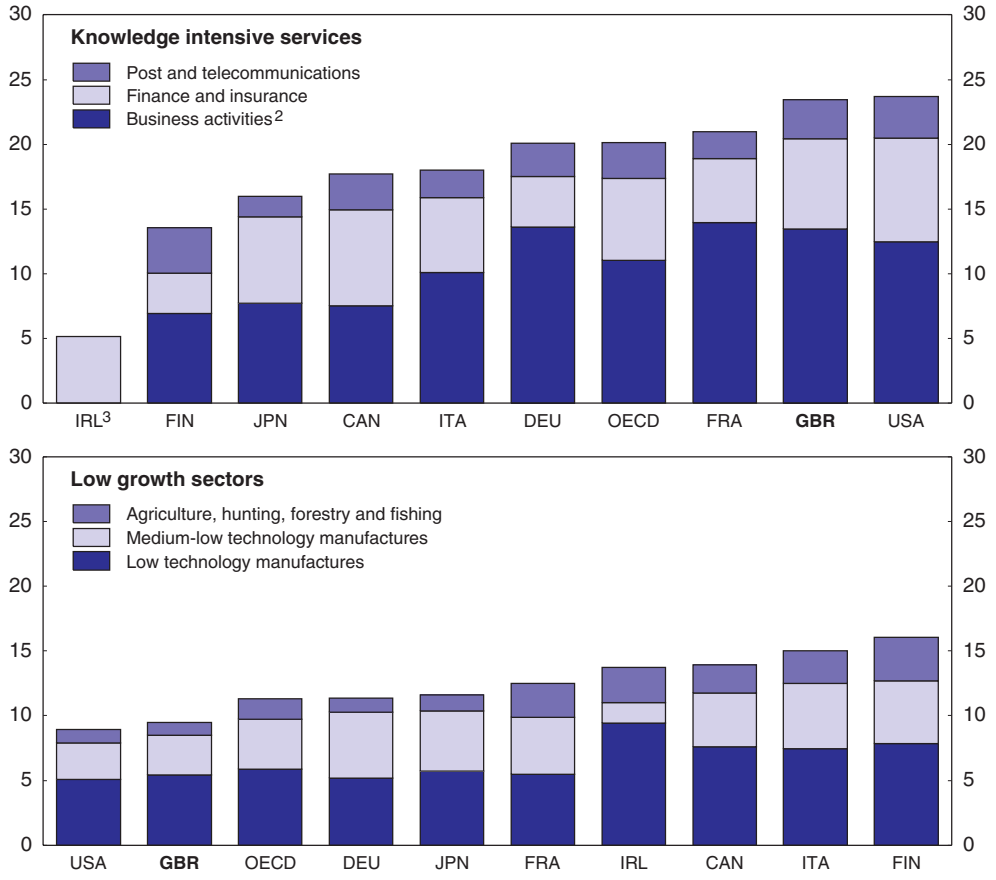
Given the UK's comparative advantage in producing services, this helps to explain the faster expansion of services relative to manufacturing (although in absolute terms manufacturing has also been growing, reflecting the success of those sectors where the United Kingdom is highly competitive). Indeed, relative to other OECD countries the sectoral composition of output in the United Kingdom is heavily slanted towards (high growth) knowledge-intensive services and away from low growth sectors (Figure 1.11).

Offshoring has enhanced productivity

There is increasing evidence that offshoring – a manifestation of the increasing fragmentation of production processes – facilitates productivity growth by allowing UK firms to specialise in core functions in which they add the greatest value-added, while re-locating lower-value-added production abroad to low cost locations. For example, Criscuolo (2006) found that a 10 percentage point increase in services offshoring intensity by British firms during 2000-03 was associated with a 0.4% increase in total factor productivity after controlling for other dimensions of global engagement, industrial affiliation, regional location, capital intensity and age. Similarly, Girma and Gorg (2004) show that services outsourcing in manufacturing industries between 1980 and 1992 was

Figure 1.11. **The sectoral composition of output**

Per cent of total value added, 2003[1]



1. 2002 for Canada, Germany and Ireland. The OECD average covers 18 countries only and shows 2001 data for knowledge intensive services and 2002 for low growth sectors.
2. Renting of machinery and equipment, computer related services, research and development, other business services.
3. No breakdown available for post and telecommunications or business activities.

Source: OECD (2006), *STAN Indicators database*, *www.oecd.org/sti/stan/indicators*.

StatLink http://dx.doi.org/10.1787/115662422741

positively correlated with productivity and that its effect was stronger in foreign-owned establishments.[17] For the United States, Amiti and Wei (2006) found that offshoring of services in US manufacturing industries between 1992 and 2000 had a significant positive effect on productivity, accounting for about a tenth of productivity growth during this period, while offshoring of goods (material) had a smaller effect accounting for approximately 5% of productivity growth.

While offshoring began as a manufacturing sector phenomenon, it is becoming increasingly prevalent in many service sectors also, particularly among firms that already have international linkages, such as multinational enterprises (MNEs).

MNEs play an important role

Theories of international trade suggest that MNEs possess advantages that allow them to compete with domestic firms in local markets despite higher cost and less knowledge of demand and local networks in a foreign country (Markusen, 1995). As such, MNEs

contribute to the host country's growth by spurring competition and facilitating the transfer of new technologies. Empirical evidence also confirms that foreign multinationals are normally more productive than domestic firms in all countries – largely because of a selection bias; only the most productive firms are able to bear the fixed costs associated with becoming multinational (Griffith *et al.*, 2004).

MNEs and FDI play an important role in the UK economy. For instance, the share of foreign-controlled affiliates' turnover in manufacturing is 35% – the second highest among the G7 economies after Canada (OECD, 2005b). Moreover, the share of workers employed by foreign MNEs is close to 20% in manufacturing and just under 10% in services. Within the services sector the involvement of foreign MNEs is particularly high in wholesale and retail trade where around 30% of employees work for foreign MNEs. However, the most frequent means by which foreign firms enter the United Kingdom is through the take-over of existing firms, rather than through green-field investment (Griffith *et al.*, 2004; OECD, 2006). Since firms that set up new plants through green-field investments are more likely to invest in the state-of-the art technology, the prevalence of firm take-overs may suggest less potential for technological spillovers and productivity gains. However, Bloom *et al.* (2007) find that being taken over by a US multinational increases information technology productivity.

Recent OECD work shows that the productivity growth of foreign manufacturing affiliates in the United Kingdom was more than 6 percentage points faster than that of domestic firms between 1995 and 2001 (Figure 1.12, upper panel) and that their contribution to overall manufacturing productivity growth was larger than in the other large OECD economies (Figure 1.12, middle panel). These findings are consistent with other empirical results suggesting that foreign-owned multinationals tend to be more productive than UK multinationals (Griffith *et al.*, 2004). A number of studies show that US multinationals outperform all others (Bloom *et al.*, 2007), while UK multinationals are on a par with other non-US foreign multinationals (Criscuolo and Martin, 2005). As well as having higher productivity growth, recent OECD work suggests that foreign affiliates also have a higher *level* of productivity in manufacturing – consistent with the idea that MNEs use superior technologies.[18] For example, Criscuolo (2005) finds that output per employee of foreign affiliates is almost three times higher than output per employee in the total UK economy. Compared with other countries, this analysis suggests that the productivity advantage of foreign affiliates is particularly high in the United Kingdom, even after the industrial composition of foreign affiliates is adjusted to match that of the domestic economy (Figure 1.12, lower panel).[19]

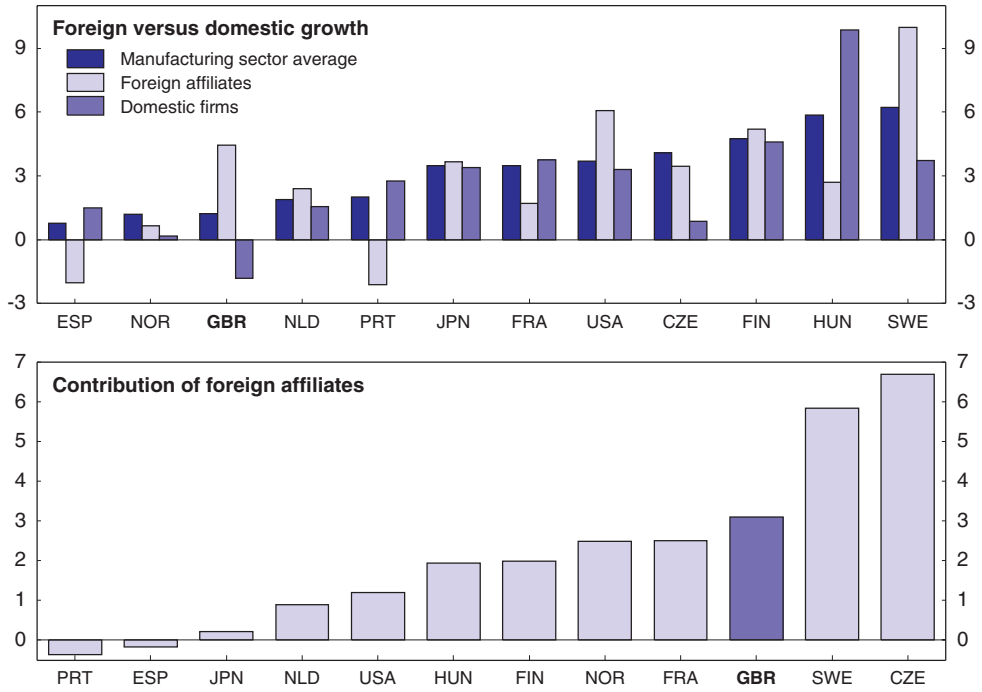
The importance of the services sector and the key role played by MNEs highlights the growing importance of the financial services sector. As a major hub, or *cluster*, of financial sector firms, the City of London plays a critical role in the economy. Although its regulatory framework for financial services remains a strength, the UK's growing tax complexity and eroding tax advantage as other countries cut tax rates faster (Chapter 5), pose a risk that the position of the City as a key financial sector cluster could become less secure. That said, the United Kingdom has gained market share of global financial business in recent years, and there is little sign such risk is imminent (Box 1.4).

Labour market tightness has been eased by high net inward migration

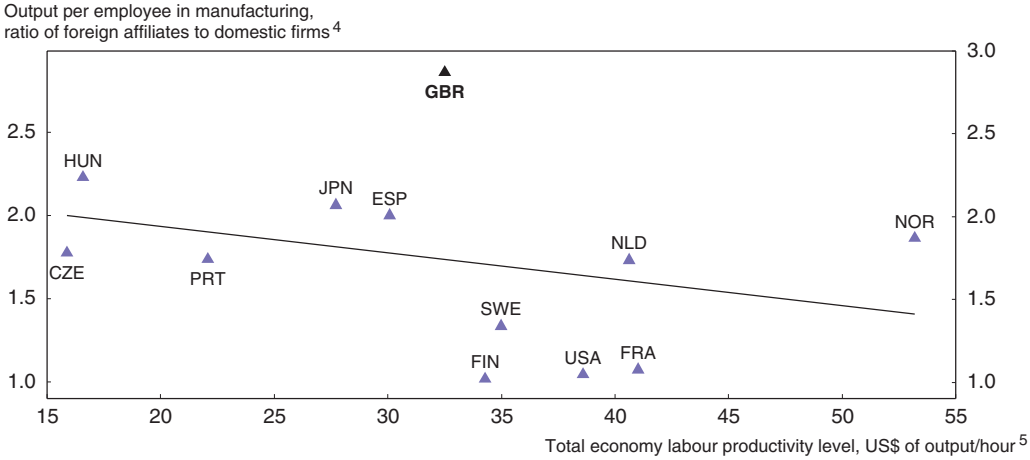
Contrary to some fears, the available evidence suggests that openness to trade and capital flows is consistent with high aggregate employment levels (OECD, 2007c; European Commission, 2005). Certainly, this is supported by the case of the United Kingdom, where

Figure 1.12. **The labour productivity advantage of foreign affiliates**

Labour productivity growth in the manufacturing sector [1]
Annual average 1995-2001, % points [2]



Relative labour productivity in foreign affiliates
2001 [3]



1. Labour productivity is measured as value added in constant prices over employment.
2. Or nearest available years: Czech Republic, Hungary and Portugal 1996-2002; Finland 1995-2002; Spain 1999-2001 and United Kingdom 1995-99.
3. Or latest year available for the ratio of foreign affiliates to domestic firms: Czech Republic 2002; Japan 2000; Hungary and the United Kingdom 1999; Portugal 1998.
4. Controls for the fact that foreign affiliates are more likely to be in high technology, high value added industries by keeping the industrial composition of foreign affiliates equal to that of domestic firms.
5. Using 2000 purchasing power parities.

Source: OECD (2006), *Productivity database*, *www.oecd.org/statistics/productivity* and Criscuolo, C. (2005), "Foreign Affiliates in OECD Economies: Presence, Performance and Contribution to Host Countries' Growth", *OECD Economic Studies*, No. 41, Vol. 2005/2.

StatLink http://dx.doi.org/10.1787/115678432266

Box 1.4. **The City: How safe is the cluster?**

The financial services industry accounts for close to 3½ per cent of employment in the United Kingdom and 8½ per cent of gross value added. As documented earlier in this chapter, this is the sector in which the United Kingdom has the largest comparative advantage, and it is continuing to gain market share: both relative to global exports of financial services and in many specific markets. For example, the UK's share of the global hedge fund industry more than doubled between 2002 and 2006 to 21%, while New York's share fell from 42% to 33%.*

More than a third of financial sector employees work in the City of London (the "Square mile" plus Canary Wharf). In turn, this sector accounts for almost 20% of GDP in London. But other financial centres are also important, most notably Edinburgh. Related professional services (accounting, legal services and management consulting) account for a further 3½ per cent of UK GDP.

History clearly plays an important role in explaining the City's importance in global financial services markets. Other factors, as summarised by Gieve (2007), which help to explain its recent growth include: the flexible labour market; the importance of English as an international language of commerce; the time zone (since the working day overlaps with Asia in the morning and America in the afternoon); the well-established financial infrastructure and telecommunications network; and the confidence that prospective market participants often have that the competitive environment is genuinely open to all. This latter point is often linked to what has been called the Wimbledonisation of the UK financial markets – the fact that the United Kingdom acts to a large extent as host to the sector, which is dominated by foreign players.

Two other factors are important. First, the "principles-based" approach to regulation of the sector is a strength. Although the principles-based approach implies a degree of legal uncertainty, the Financial Services Authority and the English legal system more generally have a reputation for predictability, and the alternative approach of setting more prescriptive rules is unable to keep up with the rapid pace of financial innovation. Second, a key basis for the competitiveness of the City is grounded in the clustering together of a critical mass of international wholesale financial activity. By bringing together a critical mass of financial expertise, individual firms can benefit not only from access to a pool of skilled labour but also from the strong external economies of scale that result from being closely located to other firms.

One potential concern of globalisation is that technological advances might encourage firms to relocate to lower-cost sites, thus undermining the synergies of clustering. However, an HM Treasury (2003a) study to investigate what impact UK euro adoption might have on the financial services sector concluded that most offshoring was of lower-value-added activities (such as back-office functions), and that core wholesale operations still saw the benefits of locating in a cluster. Indeed, they even suggested that technology may have worked in favour of clustering, by making it easier for firms to relocate activity away from their markets and towards the City cluster.

But could the whole cluster move? Not all at once of course. But if firms operating in the financial sector considered that the United Kingdom was no longer a competitive location, they could gradually relocate some or all of their activity to somewhere more competitive. It is even possible that there could be a tipping point, where the departure of one or two large banks could prompt other firms to follow. That said, in recent years, the City has been gaining business, and there is little sign that these risks are imminent. But to make sure things stay that way, policy makers should continue to emphasise sound regulatory policy, macroeconomic stability, openness, and investment in human capital while further efforts will need to be made to improve the business environment. For example, more effort needs to be made to minimise the burden of business regulation, further improve London's transport infrastructure (discussed further in Chapter 4), simplify the tax system and hold ground on tax competitiveness (Chapter 5).

* Most of the empirical estimates in this box are drawn from IFSL (2007).

the unemployment rate has trended down over the past two decades (Figure 1.1) despite increasing openness.

Another aspect of globalisation – rising migration – has also played an increasing role in the UK labour market. Until relatively recently, the United Kingdom had experienced several decades of relatively low population growth, in large part due to much lower rates of net inward migration than countries such as Australia, Canada, Germany, New Zealand, Switzerland and the United States.[20] Since the late 1990s, however, both inflows and outflows of workers have accelerated, but particularly the inflow rate. As a result, annual net inward migration has tripled, increasing from around 0.1% of the population over the 1991-96 period to around 0.3% since 2000. The greatest new influx of migrants has been from the eight new EU member countries that gained access to the UK labour market in 2004, although the net inflow of migrants from other countries has also risen.

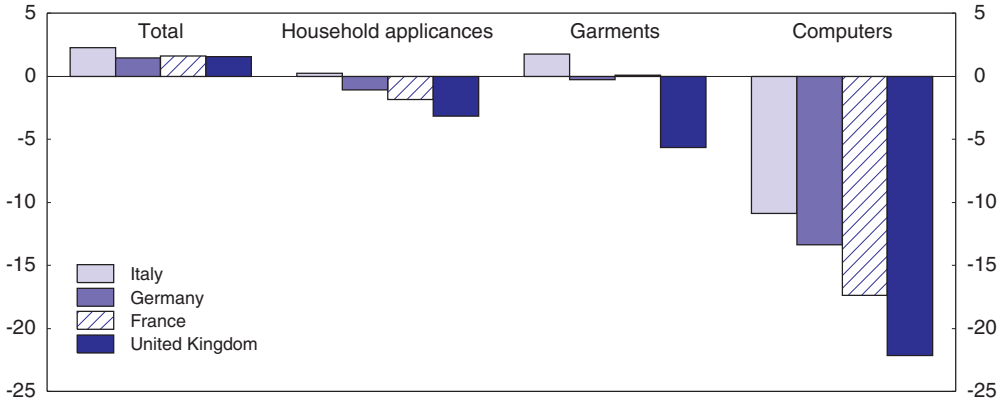
The recent inflow of migrants has coincided with an increase in the unemployment rate, but it is not yet clear to what extent these developments are linked. What is clear is that migrants have boosted the pool of available workers, they are more mobile than natives, and there is some evidence that their wages are more flexible (Blanchflower, 2007). This has helped to make the labour market more fluid and wages less sensitive to demand fluctuations. Indeed, the migrant inflow may help to explain why earnings growth has remained relatively moderate, despite reasonably strong growth and the significant pick-up in CPI inflation earlier this year (Figure 1.2). Of course, part of the explanation probably also lies with the more general decline in the bargaining strength of native workers, which has been influenced by other aspects of globalisation, such as the greater mobility of capital. The impact of migration on the labour market is discussed in more detail in Chapter 3.

Heightened competition has changed relative prices

The United Kingdom's openness to globalisation, together with flexible product markets has permitted consumer prices of some manufactured goods to fall by more than those in continental European countries that have more stringent product market regulations (Figure 1.13). This is consistent with a number of studies which find that the greater the

Figure 1.13. **Many traded goods prices have fallen by more in the United Kingdom than in the euro area**

Average inflation rate, per cent, 1997-2007[1]



1. Average for January 1997 to July 2007; year-on-year percentage change of the monthly harmonised index of consumer prices.

Source: Eurostat database (2007), Economy and Finance, June.

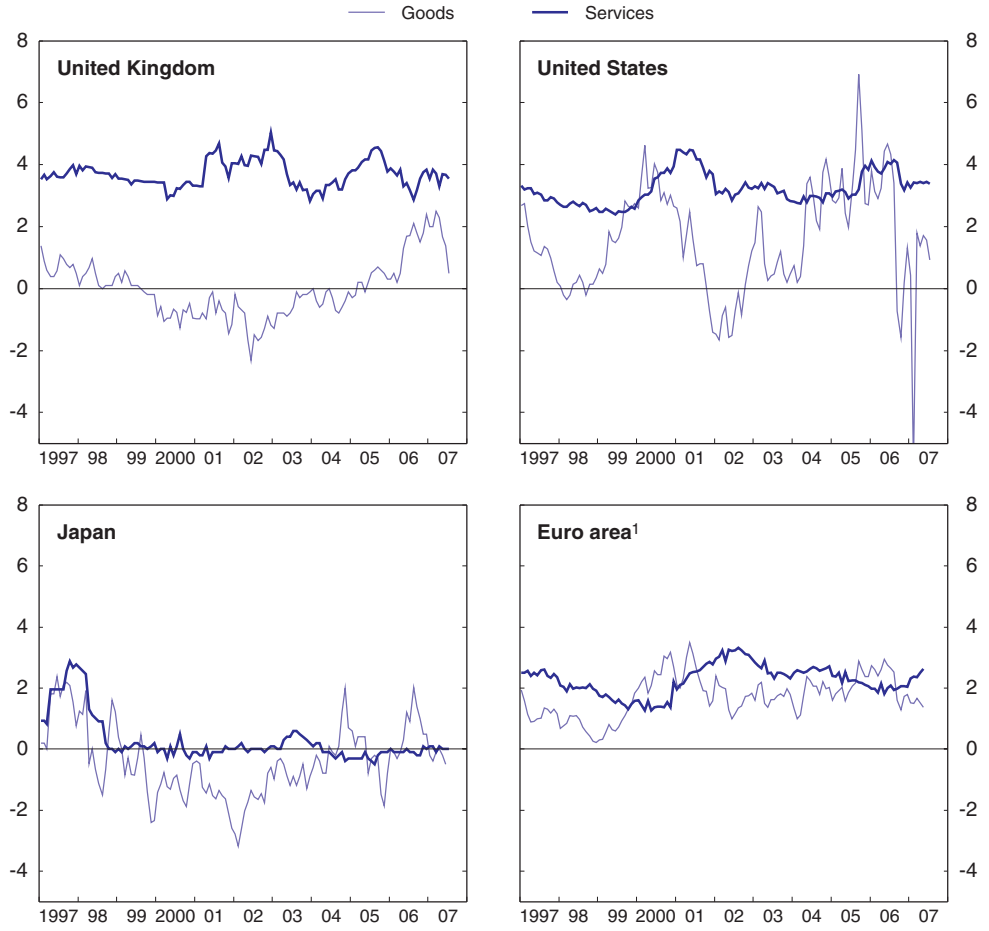
StatLink http://dx.doi.org/10.1787/115680245438

intensity of foreign competition, the greater the indirect effect of lower import prices on domestic producers in import-competing industries (see Pain *et al.* [2006] for a review).

Because the central bank aims at hitting an aggregate inflation target, lower prices of these goods have allowed other prices to rise by more than might otherwise have been the case, leading to a significant gap between services and goods price inflation (Figure 1.14).

Figure 1.14. **Goods prices inflation *versus* services**

Year-on-year percentage change



1. Twelve member countries.

Source: UK National Statistics website, *www.statistics.gov.uk*; US Bureau of Labour Statistics, Japanese Statistics Bureau and Eurostat – online databases, September 2007.

StatLink http://dx.doi.org/10.1787/115680483127

As well as putting downward pressure on some prices, globalisation has also put substantial upward pressure on the prices of oil and other commodities. Although the United Kingdom is roughly self-sufficient in oil (net imports of oil in 2006 were just 0.3% of GDP), the higher oil price still served to redistribute income towards the oil companies and the government and away from non-oil firms and households. So the risk of higher energy prices spilling over into higher wages is still an important concern for the Bank of England. Overall, there is little reason to conclude that globalisation has made the job of the central bank any easier, although it has led to significant changes in relative prices (Box 1.5).

Box 1.5. **Globalisation and monetary policy**

While much has been written about the impact of globalisation on inflation, many of its effects work in opposite directions, making its overall impact uncertain. Moreover, it is difficult to isolate the impact of globalisation from other trends (such as increased central bank credibility).

One thing that is certain, however, is that globalisation represents a shock to relative prices, while the overall price level depends on monetary policy. Thus, for an unchanged inflation rate, globalisation might imply lower prices of the manufactured goods exported by China, and higher prices for all other goods, as seemed to be the case to some extent in the early part of this decade. At the other extreme, it could imply higher prices of imported commodities (such as oil and metals) and lower prices of all other goods. The extent to which the central bank chooses to accommodate such terms of trade shocks (by permitting inflation to slide beneath the target in the first case, or to exceed it in the second) will depend on how firmly anchored medium-term inflation expectations are.

There has been considerable discussion about the extent to which globalisation may have contributed to the flattening of the Phillips curve – or the weakening of the link between inflation and measures of economic slack – that has been observed over the past decade or so. Indeed, there are some channels by which globalisation may have contributed to this flattening. First, the larger global supply of labour and the potential for offshoring have weakened the bargaining power of unions, limiting the extent of upward pressure on wages at times of strong domestic demand. Related to this, there is also some evidence that specialised agencies are used to fill specific vacancies from abroad when the UK labour market is tight (Bean, 2006). Second, increased competition from imports has put downward pressure on profit margins and reduced the procyclicality of mark-ups over marginal cost (Pain *et al.*, 2006). Firms are now more likely to respond to higher costs by putting downward pressure on other input costs and by seeking efficiency gains elsewhere. Third, the increased specialisation of trade has made inflation less responsive to domestic demand conditions (Pain *et al.*, 2006). On the other hand, other globalisation effects would tend to make the Phillips curve steeper (*e.g.* tougher global competition would tend to make wages and prices more flexible). Meanwhile, two important channels completely unrelated to globalisation are likely to have played an important role in the flattening: the improved anchoring of inflation expectations, driven by the increased credibility of central banks; and the related fact that lower trend inflation has reduced the frequency of nominal price adjustments. Empirical research to date has found it difficult to disentangle these effects and identify what impact can be directly attributed to globalisation (see Kohn, 2006), although Helbling *et al.* (2006) estimated that openness contributed to roughly half of the Phillips curve flattening, with improved central bank credibility and the low inflation environment accounting for the remainder.

To the extent that globalisation has contributed to the flatter Phillips curve, its implications for monetary policy are unclear. A flatter Phillips curve implies that the transmission of monetary policy to prices may have weakened; this would normally imply that monetary policy should be more responsive to the output gap. But at the same time globalisation may also be making the output gap even more difficult to measure than is normally the case. This is partly because excess capacity is harder to measure in the service sector, which is growing as a proportion of the economy, and also because the increased availability of migrant workers makes traditional measures of tightness in the labour market less meaningful. To some extent then, monetary policy transmission may be becoming more dependent on the exchange rate and expectations channels, which are more uncertain.

Besides the flattening of the Phillips curve, there is some evidence that the more competitive global market has reduced the pass-through from the exchange rate and from global energy prices into final goods. This has considerably assisted the job of the monetary policy makers, particularly in the face of the recent oil price shock. However, Helbling *et al.* (2006) suggest that the decline in the exchange rate pass-through might only be temporary. At the same time, the fact that globalisation has tended to push the prices of many imported goods down, while pushing energy prices up, has made many policy-makers more wary of ex-energy measures of core inflation.

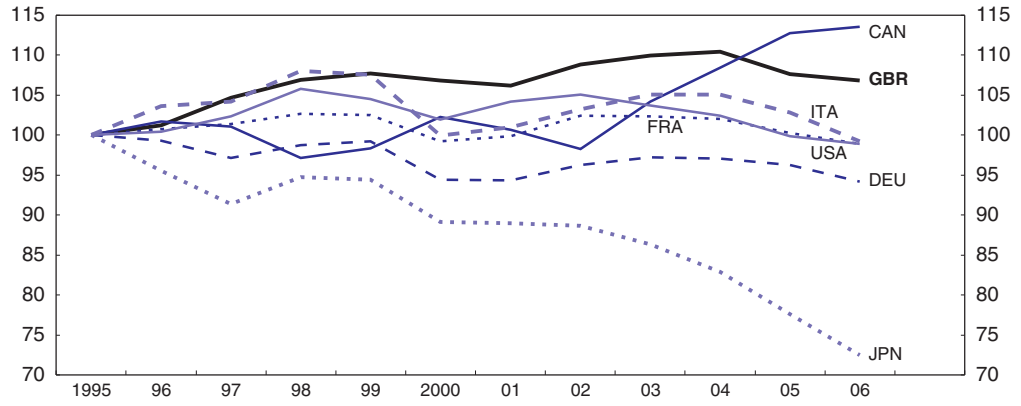
The bottom line seems to be that while globalisation-related influences have had a big impact on relative prices, they have not obviously made the job of the monetary policy makers any easier, or necessarily more difficult. As before, the challenge of conducting monetary policy under uncertainty remains, and monetary policy makers will need to remain vigilant to ensure that inflation expectations remain well anchored.

A higher terms of trade has boosted incomes

Largely because the United Kingdom has tended to import those goods which have experienced the largest price falls and because the United Kingdom is more or less self sufficient in oil, whose price has been pushed up, the terms-of-trade effect of globalisation appears to be significantly more positive for the United Kingdom than for most other G7 countries (Figure 1.15).

Figure 1.15. **The United Kingdom has benefited from a gain in the terms of trade**

Index, 1995 = 100



Source: OECD (2007), *OECD Economic Outlook: Statistics and Projections*, No. 81 – online database.

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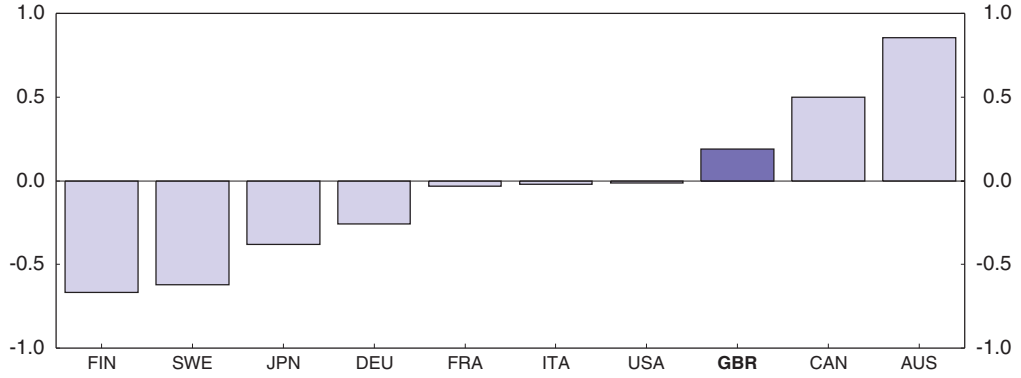
One way of looking at the overall income growth implications of terms-of-trade gains is to adjust conventional measures of volume-based growth with a terms-of-trade effect to reflect consumption possibilities. This measure of "command GDP" captures the importance of sectors such as knowledge-intensive services, where prices are increasing relative to those of manufacturing goods. This adjusted measure – also discussed in the last *Survey* – suggests that the terms of trade has added about 0.2 percentage points to growth per annum over the last decade in the United Kingdom (Figure 1.16). This is larger than in most OECD countries, except those which are major net exporters of commodities, such as Australia, Canada and Norway.[21]

Figure 1.16. **Command GDP adjustment to annual average GDP growth rate**

1995-2006, per cent per annum



Source: OECD calculations based on OECD (2007), *OECD Economic Outlook: Statistics and Projections*, No. 81 – online database.

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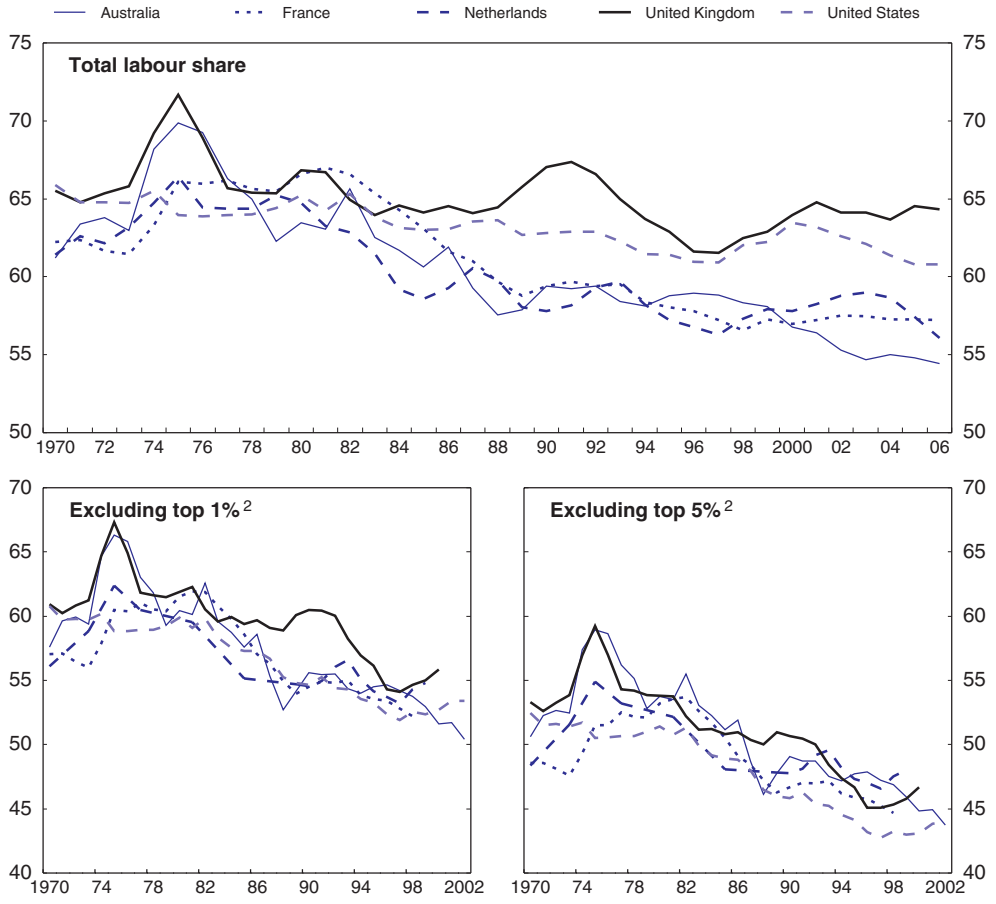
The distributional impact of globalisation depends on other policies

Because global integration has expanded the relative supply of labour in the global economy – particularly low-skilled labour – low-skilled workers in developed countries have lost some of their bargaining power. This is reflected in an increased responsiveness of domestic labour demand to the cost of labour abroad *via* trade and outward FDI (initially in manufacturing, and increasingly in services).[22]

At an economy-wide level, it could be expected that erosion in workers' bargaining power would be reflected in a declining labour share of national income. Indeed, such trends are documented by Guscina (2006), Jaumotte and Tytell (2007) and OECD (2007b), with both globalisation and skill-biased technological progress identified as explanatory factors. In the United Kingdom, however, the labour share appears to have a less notable downward trend than in some other countries (Figure 1.17, upper panel).

Figure 1.17. **Labour share of income**

Total labour compensation,[1] in per cent of GDP



1. Total labour compensation, including employers' social security contributions and imputed labour income for self-employed earners.
2. Data on top income shares are not necessarily consistent between countries and in some cases there may be breaks over time. See Atkinson and Piketty (2007) for details.

Source: OECD (2007), *OECD Economic Outlook: Statistics and Projections*, No. 81 – online database and Atkinson, A.B. and T. Piketty (2007), *Top Incomes over the Twentieth Century*, Oxford University Press.

The factors underpinning trends in the labour share are not fully understood. Nevertheless, Jaumotte and Tytell (2007) identify a number of differences in labour share patterns across countries: *i)* in countries where the labour share is declining, much of the decline can be attributed to the unskilled sectors of the economy, whereas the labour share of the unskilled sectors was quite stable in the United Kingdom; *ii)* although technical change contributed to the reduction of the labour share, its impact was smaller in the United Kingdom and the other English-speaking countries; *iii)* the English-speaking countries have also tended to mitigate falls in the labour share by introducing changes to labour market policies that have benefited the labour share by raising employment, such as policies that have reduced the tax wedge and unemployment benefit replacement. These trends seem broadly consistent with the idea that openness has permitted resources in the United Kingdom to flow into sectors of comparative advantage, where technology is increasingly used as a complement to labour, rather than as a substitute. The stability in the UK labour share is also consistent with the fact that the United Kingdom is relatively less exposed to competition from the emerging market economies than are some other countries. Finally, it is also consistent with trends in earnings growth (documented in Chapter 3), which suggest that the median worker in the United Kingdom has experienced real wage growth broadly in line with labour productivity growth in recent years, unlike the United States where median real wage growth has lagged productivity.

An important trend in income distribution (documented in Chapter 3) is the marked increase in the relative income share of the top earners (Piketty and Saez, 2006). Indeed, when the earnings of the top 1% (or 5%) earners are excluded from the measure of labour income, the adjusted labour share has deteriorated (Figure 1.17, lower panel).[23] In the United Kingdom, most of the decline occurred between the mid-1970s and the mid-1990s. Since then, the adjusted labour share has been relatively stable, despite ongoing increases in the income share of top earners.

Significant challenges remain

While the UK economy has been well positioned to benefit from globalisation, there are still concerns about the extent to which the benefits are being distributed across the population, and an up-skilling of the population will be required to cope with the labour market demands of the future. To date, the government has addressed distributional concerns through higher expenditure in key areas, such as education and poverty reduction. As fiscal constraints have become more binding, however, further expenditure increases are less feasible, emphasising the importance of achieving better value for money in public spending. Globalisation also implies increased competition for the location of businesses and investment and location decisions are affected by the quality of infrastructure, the price of office space, the regulatory environment, and by tax competitiveness. A number of these challenges are discussed in further detail below.

Raising education achievement within a tighter budget constraint

Higher educational standards and attainment is arguably the most important channel by which living standards can be sustained, and raised, in the face of ever sharper competition. Moreover, both efficiency and social justice concerns suggest that it is important to have an education system that can help to break intergenerational cycles of disadvantage. Education spending has increased, and strong efforts have been made to direct higher spending to where it would have the greatest payoffs. Yet it is difficult to

evaluate by how much education outcomes have improved. This is partly because some domestic measures of education performance may have been biased by target-driven output distortions. In addition, the lags between expenditure and outcomes are long, suggesting that some further improvements might still come.

An important concern is that the socio-economic gaps in education performance are large. The central government has attempted to address this by directing additional funds to local authorities with a higher proportion of pupils from deprived backgrounds. However, some local authorities have preferred to distribute the funds more equally between schools, undermining the central government's goal. Progress in narrowing the gaps is likely to require faster progress towards a more efficient allocation of funds.

Compared with many other OECD countries, the United Kingdom has relatively low participation by 16 and 17-year-olds in education or training. This is of concern, since globalisation suggests an increasing need for a flexible and skilled labour force that is able to re-train relatively easily in response to changing economic conditions. New financial incentives have helped to raise education participation and the government is now consulting on proposals to introduce more compulsory participation by 16 and 17-year-olds. In addition new vocational diplomas are being developed for young people who do not follow the traditional academic programmes offered at upper secondary school. Chapter 2 discusses these issues and, in the context of the challenges posed by globalisation, highlights the importance of retaining a focus on the acquisition of core literacy and numeracy skills. Given the need for fiscal restraint, the chapter suggests a number of areas where policy improvements can be made without significantly increasing outlays.

Improving work prospects for the least skilled

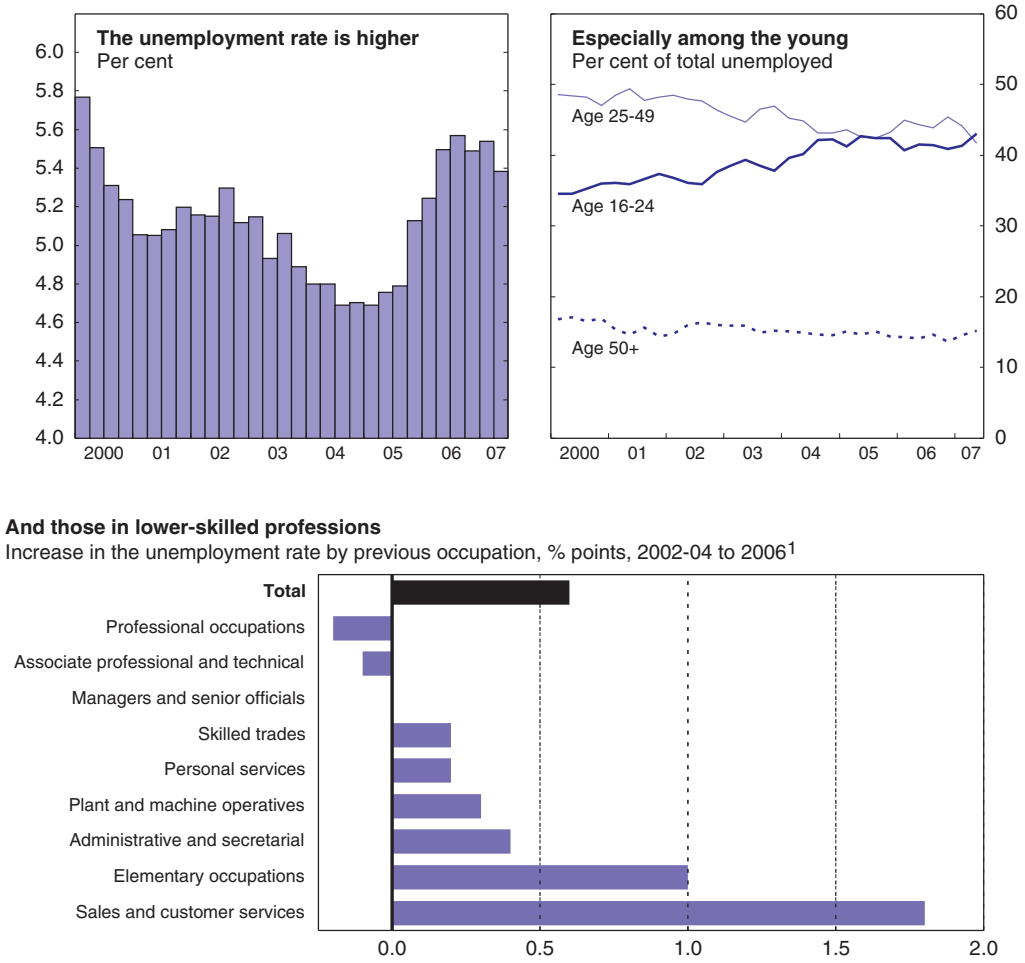
The key challenge of finding the right balance between transfers designed to reduce poverty and incentives for the low-skilled to participate in the labour market and to progress in work by working longer hours or by up-skilling is discussed in Chapter 3. Large increases in the minimum wage and new in-work tax credits have underpinned an improvement in the disposable income of the poorest workers, relative to the median. But the worsening labour market position of the least skilled is reflected in high inactivity rates, particularly among prime age males, together with higher unemployment rates among school leavers (Figure 1.18).

Up-skilling may be the best path for many workers to improve their labour market prospects, but the marginal effective tax rates for some groups of people are currently too high to make up-skilling worthwhile. Chapter 3 discusses the evidence that labour market outcomes for certain groups have deteriorated, together with policy options for improving labour market outcomes for the least skilled.

Addressing the productivity gap

While relatively strong productivity growth over recent years is gradually closing the productivity gap between the United Kingdom and the large European economies, lower labour productivity still explains most of the GDP per capita gap with respect to the United States (Figure 1.19). Moreover, after having narrowed substantially in the first half of the 1990s, the productivity gap with the United States has remained unchanged. This raises questions about whether current policy settings are sufficient to raise productivity growth and to promote the diffusion of new technologies.

Figure 1.18. **Recent unemployment trends**



1. Average of quarterly data.

Source: National Statistics website, *www.statistics.gov.uk – Labour Force Survey, Historical Quarterly Supplement* and *Economic & Labour Market Review*.

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Recent productivity trends are discussed in more detail in Chapter 4, with a number of key weaknesses being identified as explanatory factors. An important area of weakness is the UK planning system and restrictions in business' access to land, which constitute an important barrier to lifting the UK's productivity performance. To address this situation the government commissioned the Barker Review which made a number of suggestions on how the system could be improved by ensuring that more weight is given to economic issues in the planning process. The Barker Review recommendations are being taken forward *via* the Planning White Paper and proposed Planning Bill. However, indications to date are that the government will not follow through on all of the Barker Review recommendations.

Another area of weakness is transport infrastructure, which suffered a long period of underinvestment (both in roads and the railways) over many decades. Railway ownership underwent dramatic reforms over the 1990s and, following the release of the Ten Year Plan for Transport in 2000 and a couple of fatal railway accidents, spending on railway infrastructure has increased. In contrast, investment in road transport remains low by historical standards, although there are currently plans underway to trial road-user pricing

Figure 1.19. **There is still a substantial productivity gap with the United States**

2005

1. Based on 2005 purchasing power parities.
2. Total hours worked per capita.
3. GDP per hour worked.

Source: OECD (2007), *Productivity database*, March, *www.oecd.org/statistics/productivity*.

StatLink http://dx.doi.org/10.1787/115760302587

schemes which, if extended nationwide, should provide major congestion benefits. However, this is probably at least a decade away. Further efforts to improve infrastructure are needed.

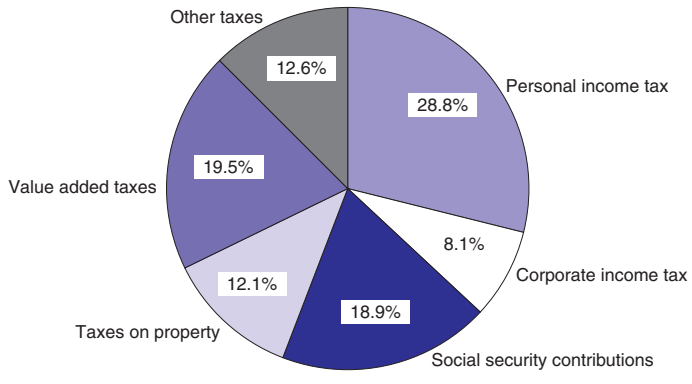
The Davidson Review 2006 was commissioned to look at the extent to which red-tape and business regulation was impeding business activity and the subsequent 2006 Legislative and Regulatory Reform Act gave the government the power to amend primary legislation by "Legislative Reform Order" (LRO). These new order-making powers are focussed on better regulation outcomes, but more needs to be done, and progress on this front needs to be monitored. Chapter 4 provides more background on how these areas of weakness may impede productivity growth and discusses the policy options for reform. Other key challenges, such as the low general level of skills of the adult population, are also discussed.

Holding ground on tax competitiveness

Concerns have been voiced that greater openness will erode tax revenues, while globalisation raises demands for government programmes that cushion the impact of economic changes. However, internationally mobile activity represents a relatively small proportion of revenues, with corporate tax revenues making up only 8% of the total tax take (Figure 1.20).

Figure 1.20. **Tax revenue by source**

Per cent of total tax revenue, 2004



Source: OECD (2006), *Revenue Statistics*.

StatLink http://dx.doi.org/10.1787/115768355348

Corporate tax revenues as a share of GDP have not declined, at least to date, despite lower statutory tax rates. Moreover, to the extent that embracing globalisation enhances economic growth, it also implies a larger potential tax base which could strengthen the provision of social welfare, rather than diminish it (Hines, 2006).

Statutory corporate tax rates have declined substantially in the United Kingdom and elsewhere, while tax bases have been broadened. This has rendered corporate tax systems more efficient. While declining tax rates are consistent with tax competition, they do not prove that it has been taking place. But there is a considerable amount of evidence that countries compete on the location of business investment, the location of business headquarters and where company profits get taxed.

The United Kingdom was early in cutting the corporate tax rate and had strong tax competitiveness until the mid-1990s. In the meantime, other countries have caught up and many smaller European countries have considerably lower tax rates, even after the recent announcement to cut the corporate tax rate from 30% to 28% in 2008. However, the UK tax rate is the lowest among the G7 countries, although pressures to cut rates will continue. Chapter 5 looks at the various options to preserve tax competitiveness; these include further tax cuts and base broadening, reducing the complexity of the corporate tax system, and shifting taxation to less mobile factors. More radical options to overhaul the corporate tax system are also discussed; all have some advantages, if also significant drawbacks.

Notes

1. Citizens from two of the accession countries already enjoyed relatively free access to the UK labour market prior to EU expansion. Ireland and Sweden also permitted free movement and the right to work from 1 May 2004, and Finland, Greece, Italy, Portugal and Spain followed suit in 2006. In contrast, public opinion on immigration has become more negative in recent years, leading the United Kingdom to impose restrictions on workers from Bulgaria and Romania when they joined the European Union in January this year.
2. These international comparisons are based on a comparison of GDP per capita converted to US dollars using 2000 purchasing power parities (OECD *National Accounts* database).
3. HM Treasury (2005) summarised the six key policy challenges for the United Kingdom in responding to globalisation as: *i)* entrenching macroeconomic stability in a more integrated global economy; *ii)* building an enterprising and flexible business sector where firms can succeed and seize the opportunities presented by a more open and competitive global economy; *iii)* promoting innovation to drive forward scientific research and knowledge-driven industries; *iv)* opening the acquisition of skills to secure the right skills profile for the global economy; *v)* ensuring fairness to provide security for those who need it while providing incentives to work and save; and *vi)* increasing the energy and resource efficiency of the economy.
4. The links between consumption and housing were discussed in Chapter 2 of the previous *Survey*.
5. For example, see HM Treasury, Budget 2007.
6. Honjo (2007) shows that a rolling forward-looking version of the golden rule (*i.e.* a forward looking rule aiming for "balance" over the cycle), would avoid the risk of pro-cyclicality but in doing so impose a looser constraint on debt over any given cycle.
7. For example, this would be the case as long as the current budget balance averages zero and nominal GDP grows by 5% per annum.
8. For example, it was announced that the unfunded pension liabilities of the NHS rose to £165 billion at 31 March 2006 from £131 billion at 31 March 2005 and from £103 billion at 31 March 2004. Eighteen billion pounds of the most recent re-valuation stemmed from the 1 April 2005 change in the Government Actuary's Department discount rate from 3.5% to 2.8% (House of Commons, 2007b). The liabilities of other public sector pension funds are likely to be similarly revised.

9. For example, cyclical revenue windfalls are often directed into government programmes that tend to be permanent.

10. OECD projections published in the *Economic Outlook* No. 81 (June 2007) suggest that total government disbursements as a percentage of GDP in the United Kingdom will surpass those of Germany in 2007.

11. Fiscal drag refers to the additional tax revenues that are raised by allowing tax allowances and thresholds to increase in line with retail prices rather than earnings. The Treasury estimates that fiscal drag increases current revenues by 0.2% of GDP per annum (HM Treasury, 2003b).

12. See the OECD *Economic Globalisation Handbook*. For example, in 2005 and 2006 the United Kingdom received the highest level of inflows in the OECD ($165 billion, three times higher than FDI inflows in 2004). This figure was boosted by several large cross-border take-overs, such as the early 2006 take-over of Peninsular & Oriental Steam Navigation Company by Dubai Ports World (OECD, 2006).

13. Canada's value added share of manufacturing has remained broadly stable since 1980.

14. For further discussion about the RSCA analysis see Rae and Sollie (2007).

15. While Ireland also appears to be exposed to competition with the emerging markets, this largely reflects Ireland's specialisation in information technology related manufactures. A correlation based on more disaggregated data (1 033 categories) reveals less exposure for Ireland. However, for the United Kingdom the more disaggregate analysis seems to be less appropriate because of the much greater importance it attaches to the manufacturing sectors relative to the service sectors.

16. The terms outsourcing and offshoring are often used interchangeably. Both can be used to describe the process of purchasing intermediate goods and services from foreign suppliers, although outsourcing can also be done domestically, while offshoring always refers to inputs being sourced from abroad and also incorporate international insourcing (importing goods or services from foreign affiliates of domestic parent companies).

17. The study covered the chemical, mechanical and instrument engineering and electronics industries.

18. In services and in low-tech manufacturing sectors the largest contribution of foreign affiliates was due to an increase in employment shares of foreign affiliates, while in medium and high-technology sectors the contribution was mainly driven by stronger productivity growth of existing foreign affiliates.

19. In general it was found (in both the OECD and in the United Kingdom) that the productivity advantage of foreign affiliates was smaller in high-technology sectors (such as chemicals and pharmaceuticals, and machinery and equipment) than in low-technology manufacturing. One explanation for this might be that these high-technology sectors have already been more exposed to global competition through trade.

20. Between 1991 and 1996 the UK population increased by around 0.25% per annum, compared with over 1% per annum in Australia, Canada, New Zealand and United States. More recently, UK population growth picked up to around 0.6% in 2004 and 2005.

21. Norway is an extreme case, with a command GDP adjustment of more than 2½ percentage points. Australia (shown in Figure 1.16) is the second largest. At the other end of the scale, Korea has a particularly large negative adjustment (–2.2 percentage points).

22. OECD estimates suggest that the wage elasticity of labour demand increased from about 0.2 to 0.5 in absolute value between 1980 and 2002, with the evidence for this increase being strongest for manufacturing, one of the most exposed industries. Globalisation, and in particular offshoring, may have played a significant role in causing this change by allowing firms to more flexibly respond to shocks *via* changes in the mix of production at home and abroad (OECD, 2007b).

23. The adjusted labour share is calculated by re-classifying the earnings of the top 1% income earners as a return to (human) capital rather than labour. This share averaged around 6-7% during the 1970s, before gradually increasing to close to 10% by 1990 and 13% by 2000 (Atkinson, 2007). Similarly, the earnings of the top 5% rose from 17-18% in the 1970s to 27% by 2000.

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ANNEX 1.A1

Progress in structural reform

This annex reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Recommendations	Action taken since the previous *Survey*
Housing market	
Monitor closely the speed and efficiency of the planning system and progress towards the government's regional housing targets.	Progress is being made towards the government's target of 200 000 homes a year by 2016; net additions rose in 2006 to 185 000 (from around 160 000 in 2005). Planning performance has also improved with over 70% of local authorities now meeting targets for speed, up from around 20% in 2002.
Reform the planning system to increase its responsiveness to housing demand as well as providing greater incentives for local authorities to meet housing growth targets, *e.g.* by disregarding for a period council tax receipts generated by new housing from the calculation of the local authorities grant allocation from central government.	The government has consulted on a proposal to introduce a new Housing Delivery Grant to further improve incentives for housing delivery.
Reform the council tax to make it more proportional to property values and based on more frequent and up-to-date valuations.	Sir Michael Lyons' Independent Review of local government finance in England concluded in March 2007 that revaluation is an important task for a future government.
Public sector management	
Further improve incentives faced by providers of health and education, for example by introducing incentive pay for hospital doctors, and further involving private sector providers to ensure contestability.	The private sector has continued to be involved in providing capacity to the National Health Service (NHS). Take-up of the wave 1 contracts has continued to rise, exceeding 90% of the contracted volumes in recent months, promoting contestability throughout the NHS. The role of private sector providers is increasing in a number of other areas, including the construction of schools (through private finance initiatives) and provision of training providers available to employers. The government is continually reviewing contracts for NHS doctors, and considering the role of incentives. Incentive pay is being brought into the teacher pay system.
Free up additional government resources by applying an interest rate close to government borrowing costs to student loans, rather than a zero real interest rate.	The government plans to appoint an independent panel to review all aspects of the policy, including interest rates, in 2009.
Transport infrastructure	
Maintain investment in transport infrastructure at least at the levels envisaged in long-term spending plans and examine any persistent undershoot with a view to taking remedial action. Consider the case for further raising expenditure on strategic roads.	The Eddington Review has improved the evidence base as regards the case for additional expenditure on transport. This evidence will feed in to the Comprehensive Spending Review, which will address overall investment in transport.
Monitor incentives for local authorities to pursue local congestion charging schemes, *e.g.* by making funds from the Transport Innovation Fund available sooner or by making planned increases in funding for local transport contingent on local plans to tackle congestion.	Funding has been made available to ten local authorities for trial congestion schemes. Incentive funding linked to Local Transport Plans was contingent in part on local congestion strategies. The Congestion Performance Fund has been announced, offering increases in funding to those areas with the greatest congestion problems to go beyond existing local targets, with the first allocations under this scheme being announced.

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Recommendations	Action taken since the previous *Survey*
Consider directing more subsidies to railway lines which have the greatest potential for relieving road congestion.	New franchise agreements require train operators to increase capacity where possible. The government will soon set out the capacity increases (including new rolling stock and infrastructure) which it expects the rail industry to provide over the period 2009-14, and for which the government will contribute to funding.
Find further measures for more closely integrating investment decisions between railway infrastructure and train operations.	A process is underway to specify the capacity, punctuality and other improvements the government wants the industry to deliver. The industry will identify the specific measures it proposes to secure these improvements. This process concentrates on high level outputs rather than specific projects, enabling the industry to identify complementary operational and infrastructure measures capable of delivering passenger benefits.
Pensions	
Simplify the pension system by reducing excessive reliance on means-testing. For example, by raising the basic state pension and indexing it to future earnings rather than prices, with the fiscal costs to be partially covered by raising the state pension age in line with increasing life expectancy and by introducing a cap on tax subsidies to pension savings.	The government has proposed to: link the basic State Pension to earnings from 2012 (subject to affordability); introduce measures to improve coverage for women and carers; simplify the State Second Pension; restrict the spread of means-testing; and raise the state pension age to 68 by 2050 in line with increases in average life expectancy. These proposals are currently before parliament.
Facilitate reforms to promote other sources of income during retirement, such as through mortgage equity release products.	The UK government introduced legislation to bring home reversion plans within the scope of Financial Services Authority (FSA) regulation, establishing a level regulatory playing field in the equity release market. The FSA regime took effect in April 2007.
Consider imposition of some form of mandatory savings in the medium term.	The government has announced proposals to introduce a new system of simple, low cost personal accounts from 2012, along with auto-enrolment and mandatory employer contributions, to encourage low to moderate earners to save for retirement.
Child care	
Give support for child-care and nursery education priority over extending paid maternity leave. Evaluate the effects of 9 months paid leave before committing to the extension of paid leave to a full year.	Paid maternity leave was extended from 26 to 39 weeks from April 2007. It is therefore too early to evaluate the effects of this specific change, ahead of the government fulfilling its goal of 52 weeks paid maternity leave by the end of this parliament.
Consider ways of developing the quality and flexibility of the supply of child-care services.	The government introduced a £250 million Transformation Fund to improve the quality of the child-care workforce, and aims to have a graduate leader in every full day-care setting by 2015. All local authorities have a statutory duty to ensure sufficient child care, as far as is reasonably practicable, for all parents who need it in order to work or access training. This will involve ensuring the availability of flexible child-care services where the demand exists.
Labour market	
Continue to roll out the Pathways to Work programme nationally. Extend it to a wider range of existing claimants when there is sufficient capacity.	Pathways to Work currently covers around 40% of the country. By 2008 Pathways will be rolled out to the remaining 60% of the country where it is to be delivered by the private sector and other non-profit organisations. In most areas Pathways is only mandatory for new claimants but existing claimants can volunteer on to the programme. To date about 1 in 15 Pathways' participants have been existing claimants. Localised trials are being conducted on making Pathways mandatory for existing claimants. The findings of these pilots will inform future national decisions on policy for existing claimants.
Make the transfer to the incapacity benefit less automatic by involving specialised occupational health teams earlier in the process of eligibility assessment.	The Welfare Reform Act 2007 will replace the current system of incapacity benefits with a new integrated and simplified Employment and Support Allowance (ESA). ESA will have a clearer balance of rights and responsibilities than the current system. In parallel with the introduction of ESA the Personal Capability Assessment (PCA) – the eligibility test conducted at the start of an incapacity benefit claim – will be changed so screening of applicants is more stringent.

Recommendations	Action taken since the previous *Survey*
Consider shifting health care resources towards mental health.	The government continues to allocate growing volumes of resources to mental health. Between 2001/02 and 2005/06 (latest spending figures available) spending increased by 25% or £983 million.
Innovation policy	
Evaluate the effectiveness of research and development (R&D) tax incentives before extending their generosity.	In 2006 the United Kingdom commissioned an independent consultancy to conduct a feasibility study into whether an econometric evaluation of the scheme would be possible. The study concluded that it is still too early. The United Kingdom plans to do a full evaluation of the scheme as the data becomes available.
Reconsider the balance of direct funding for R&D between SMEs and larger companies who receive most current support.	The government's main source of direct funding for R&D in both small and medium-sized enterprises (SMEs) and large companies is the Department of Trade and Industry (DTI) Technology Strategy (£178 million a year), which will be administered by an independent agency from July 2007, with an enhanced remit to support innovation across all sectors of the economy. The Sainsbury Review is developing recommendations on how support for innovative SMEs can be further improved. Budget 2007 announced a more generous R&D tax credit system for SMEs, subject to state aid clearance. The small business research initiative (SBRI) aims to encourage more high-technology small businesses to grow and develop new research capacities. Government departments should purchase at least 2.5% of their R&D from SMEs. The Sainsbury Review of Science and Innovation is reviewing the scheme, and will report this summer. SBRI operates within the EU legal framework, which means that it is not legally permissible to advertise SBRI contracts as being solely for SMEs or for UK-based companies.
Further promote university-business collaboration, *e.g.* by streamlining university governance procedures and providing clearer guidelines concerning intellectual property rights.	The government is providing £110 million a year support for business-university collaboration in England through the Higher Education Innovation Fund, and has published a set of model intellectual property agreements that businesses and universities can use as templates. The Gowers Review reported in December 2006 with a set of recommendations for modernising the UK's intellectual property regime, which the government is taking forward. The Sainsbury Review is developing recommendations on how knowledge transfers between businesses and universities can be further improved.
Skills	
Do more to improve basic literacy and numeracy so as to provide a stronger foundation for continued learning.	The government recently met its interim target for tackling basic skills challenges in the adult population – over 1.6 million adults have improved their basic skills since 2001. The government has carried out a small-scale trial of new functional skills qualifications in mathematics, English and information and communication technology (ICT), and is developing full qualifications for piloting from September 2007. Full roll out is planned from 2010, with functional skills featuring both as a discrete qualification for young people and adults and as part of GCSE, the new diplomas and apprenticeships.
Unify the current array of vocational programmes and diplomas into a limited number. Work with the universities to ensure that the new diplomas give sufficient pathways to continued education including with foundation degrees.	New qualifications are being developed to replace and rationalise the current complex range of provision and qualifications. The reform will create a coherent system of units and qualifications that are easier for learners and employers to navigate, and are focused on skills for life and work, subject and vocational based learning, and personal and social development. Higher education institutions are integrally involved in the development of diplomas, so as to ensure that the qualifications are designed with the possibility of progression into higher education.

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Glossary

A8	Eight countries that joined the EU in 2004 (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia)
ACT	Advanced corporation tax
AEN	Additional educational needs
AETR	Average effective tax rate
AR	Average of relatives
CPI	Consumer price index
CVA	Contextual value added
DEL	Departmental expenditure limit
DfES	Department for Education and Skills
DSG	Dedicated schools grant
DTI	Department of Trade and Industry
DWP	Department for Work and Pensions
EMA	Education maintenance allowance
ESA	Employment and support allowance
EU	European Union
EU15	European Union, first 15 member states
FDI	Foreign direct investment
FSM	Free school meals
G7	Group of 7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and United States)
GCSE	General Certificate of Secondary Education
GDP	Gross domestic product
GM	Geometric mean
HICP	Harmonised index of consumer prices
HMRC	HM Revenue and Customs
IALS	International adult literacy survey
ICT	Information and communication technology
IPS	International passenger survey
LA	Local authorities
LFS	Labour force survey
LHA	Local housing allowance
METR	Marginal effective tax rate
MFG	Minimum funding guarantee
MFP	Multifactor productivity
MNE	Multinational enterprise
NAO	National Audit Office
NHS	National Health Service

NINo	National insurance number
OFSTED	Office for Standards in Education
ONS	Office for National Statistics
PCA	Personal capability assessment
PFI	Private Finance Initiative
PIAAC	Programme for international assessment of adult competences
PIRLS	Progress in international reading literacy study
PISA	Programme for international student assessment
R&D	Research and development
RA	Ratio of averages
RPI	Retail price index
RPIX	Retail price index excluding mortgage interest payments
RSCA	Revealed symmetric comparative advantage
SEN	Special educational needs
SME	Small and medium-sized enterprises
TFP	Total factor productivity
TIMSS	Trends in international mathematics and science study
VAT	Value added tax
UK	United Kingdom
US	United States
WRS	Worker registration scheme

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Table of contents

Boxes

Tables

Figures

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of the United Kingdom were reviewed by the Committee on 5 September 2007. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 14 September 2007.

The Secretariat's draft report was prepared for the Committee by Anne-Marie Brook, Åsa Johansson, Petar Vujanovic and Marte Sollie under the supervision of Peter Hoeller. Research assistance was provided by Desney Erb.

The previous Survey of the United Kingdom was issued in November 2005.

BASIC STATISTICS OF THE UNITED KINGDOM (2006)

THE LAND

Area (2005, 1 000 km^2)	
Total	242
Agricultural	185

Major cities (2005, thousand inhabitants)	
Greater London	7 518
Birmingham	1 001
Leeds	723
Glasgow (local government district)	579

THE PEOPLE

Thousands	
Population	60 587
Net increase (annual average 2001-05)	274
Number of inhabitants per km^2	250

Total labour force (thousands)	30 630
Civilian employment (% of total)	
Agriculture, forestry and fishing	1.3
Industry and construction	22.0
Services	76.4

PRODUCTION

Gross domestic product	
In £ billion	1 300
Per head ($)	39 519

Gross fixed capital investment	
In % of GDP	18.1
Per head ($)	7 138

THE GOVERNMENT

Public consumption (% of GDP)	22.1
General government (% of GDP)	
Current and capital expenditure	44.6
Current revenue	41.6
Net debt	39.5
Last general elections: 5 May 2005	

Composition of House of Commons (seats)	
Labour	351
Conservatives	195
Liberal Democrat	63
Other	37
Total	646

FOREIGN TRADE

Exports of goods and services (% of GDP)	28.4
Main commodity exports (% of total)	
Electrical machinery	22.7
Manufactured goods and articles	22.0
Chemicals	15.2
Mechanical machinery	11.6

Imports of goods and services (% of GDP)	32.6
Main commodity imports (% of total)	
Manufactured goods and articles	25.2
Electrical machinery	25.0
Road vehicles	10.0
Fuels	9.8

THE CURRENCY

Monetary unit: Pound sterling

August 2007, monthly average of spot rate	
£ per $	0.497
£ per €	0.677